June 25, 2014

2014 Proxy Season Review

Shareholder Proposals on Board Declassification, Majority Voting and Elimination of Supermajority Provisions Continue to Receive Strong Support and Begin Migration to Smaller Companies; Handful of "Golden Parachute" Proposals Achieve Majority Support for the First Time; Board Responsiveness Continues to Be a Key Driver of Withhold Votes

SUMMARY

During the 2014 proxy season, governance-related shareholder proposals continued to be common at U.S. public companies, including proposals 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 the right to act by written consent. While the number of these proposals was down from 2012 and 2013 levels, this decline related entirely to fewer proposals being received by large-cap companies, likely due to the diminishing number of large companies that have not already adopted these practices. Smaller companies, at which these practices are less common, have not seen a similar decline and, if anything, are increasingly being targeted with these types of proposals.

Shareholder proposals on social issues (particularly those related to political contributions and lobbying costs) and compensation-related issues (particularly those relating to acceleration of vesting upon a change-in-control and stock retention) also remained common but, as in the past, these proposals generally received far lower support than governance-related proposals. However, a handful of proposals relating to acceleration of vesting upon a change-in-control (so-called "golden parachutes") actually achieved majority support in 2014, which has almost never happened in prior years.

In addition, during the 2014 proxy season, U.S. public companies continued to have, on average, strong results on their advisory say-on-pay votes, reflecting companies' success in engaging with shareholders, understanding and anticipating their concerns, and communicating the company's actions and positions.

In the area of director elections, 2014 saw an increase in negative recommendations from proxy advisory firms and low vote results for directors as a result of a perceived lack of responsiveness to shareholder

concerns. This increase is likely due, at least in part, to new policies of Institutional Shareholder Services, the proxy advisory firm, that call for withhold recommendations for directors who fail to implement a shareholder proposal that received the majority of *votes cast* (as opposed to votes outstanding) in the prior year.

In this publication, we:

- Quantify and discuss various categories of shareholder proposals voted on this season, and highlight important trends and legal developments;
- Discuss developments in the use by companies of litigation as an avenue to exclude shareholder proposals, including challenges posed by recent decisions on the issue of standing;
- Analyze the key reasons that directors of U.S. companies received “withhold” or “against” recommendations from ISS[1] in 2014, and the impact of these recommendations on voting results;
- Discuss the primary drivers of negative recommendations by ISS on say-on-pay proposals;
- Analyze the results from 2014 say-on-pay votes, including the greater success of large companies in avoiding problematic vote 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 2014 proxy season developments. Information on this webinar will be disseminated shortly.

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[1] We focus in this publication on recommendations by Institutional Shareholder Services 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

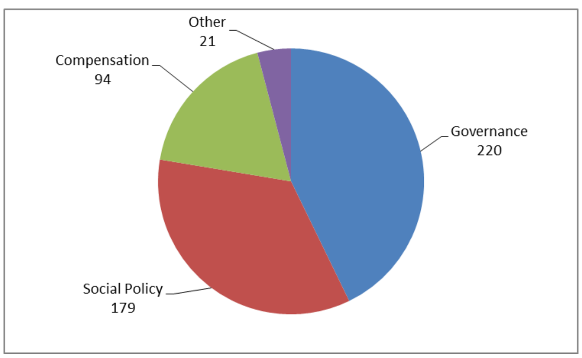
A. OVERVIEW OF SHAREHOLDER PROPOSALS IN 2013 AND 2014

The following table and pie charts summarize, by general category, the Rule 14a-8 shareholder proposals voted on at U.S. companies in 2013 and 2014, and the rate at which they passed.[3]

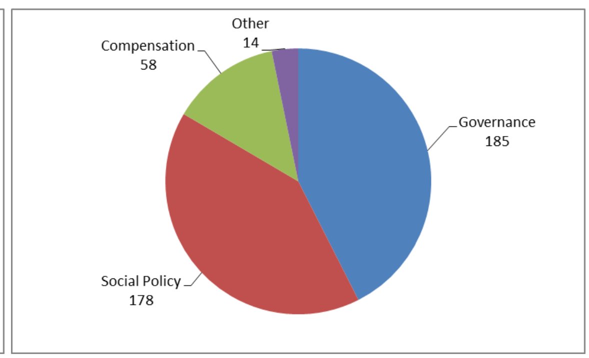
SUMMARY OF 2013 AND 2014 SHAREHOLDER PROPOSALS

	Total Shareholders Proposals Voted On		*Average % of Votes Cast in Favor*		*Shareholder Proposals Passed*	
Type of Proposal	*2014*	*2013*	*2014*	*2013*	*2014*	*2013*
Governance (Board/Voting Structure)	185	220	44%	47%	51	85
Social and Political Issues	178	179	22%	21%	4	3
Compensation-Related	58	94	28%	27%	5	1
Other	14	21	32%	18%	2	2
Total	435	514				

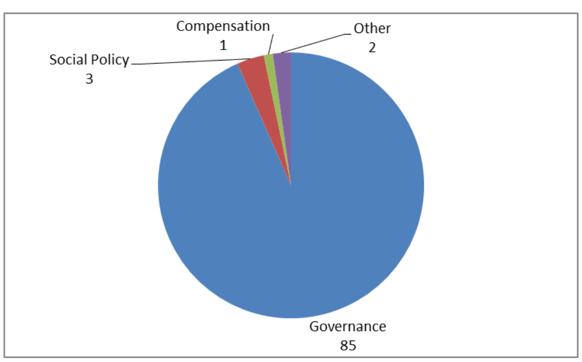
Proposals Voted on in 2013



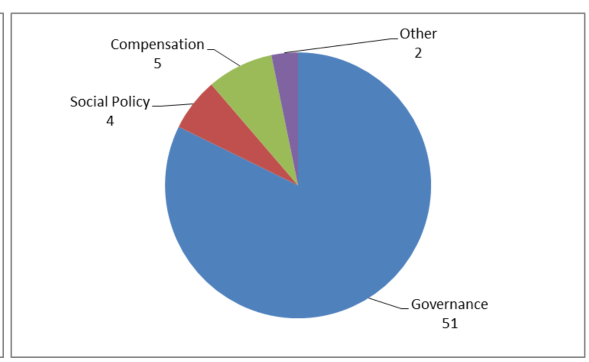
Proposals Voted on in 2014 (YTD)



Proposals That Passed in 2013



Proposals That Passed in 2014 (YTD)



3 By "pass" we mean that the proposal received the support of a majority of votes cast, regardless of whether this is the threshold for shareholder action as a state law matter. See footnote 38 for a further discussion. Throughout this publication, information on voting results for 2014 year-to-date generally includes annual meetings through June 13, 2014. Over 85% of the S&P 500 companies had their 2014 annual meetings by that date.

As indicated above, companies still receive a large number of social, political and compensation-related proposals, though it is still the case that the vast majority of proposals that pass are those relating to governance issues. However, perhaps the most notable developments in 2014 are:

- the overall decline in governance-related proposals in 2014, largely due to the fact that there are fewer large companies that still have the types of governance practices that are the most frequent targets of these proposals. See Section I.C below for a further discussion.
- the fact that, although the absolute number of compensation-related proposals declined, a handful—specifically, those relating to "golden parachute" arrangements—actually received majority support, which had been exceedingly uncommon in the past. These proposals are discussed further in Section I.E below.

B. COMPANIES THAT RECEIVED SHAREHOLDER PROPOSALS

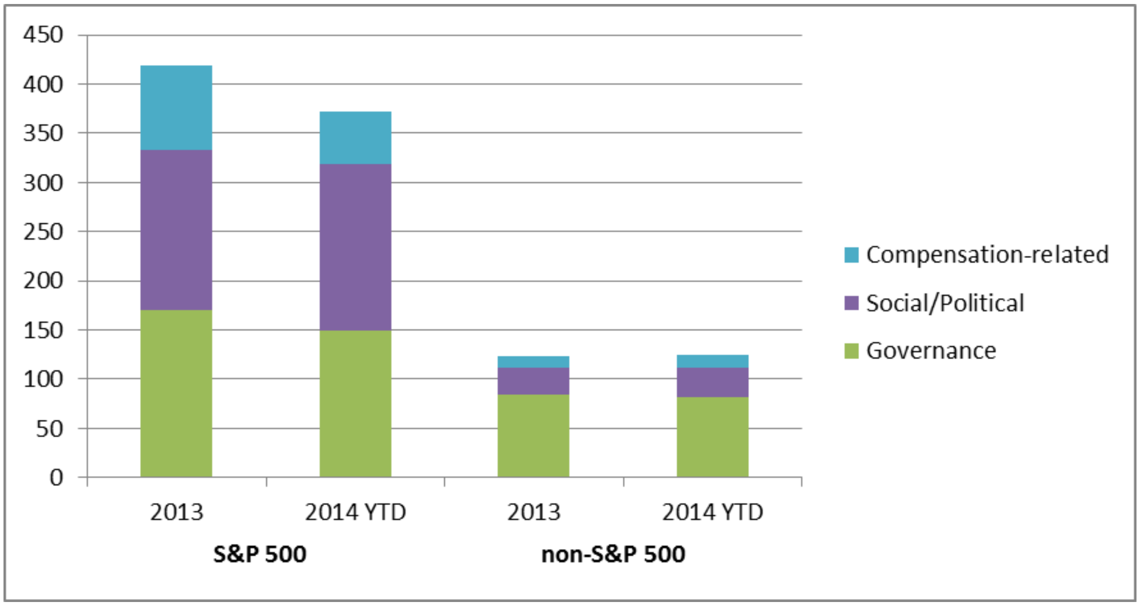
Before turning to a detailed discussion of the various categories of shareholder proposals received by U.S. public companies in 2013 and 2014, it is worth taking a moment to focus on *which* companies generally receive these proposals. Traditionally, the vast majority of shareholder proposals have been received by large-cap companies. Over time, this has led to a bifurcated corporate governance landscape, with so-called "shareholder-friendly" governance structures, such as destaggered boards, majority voting, special meeting and written consent rights and simple majority vote thresholds, being much more common at larger companies than smaller companies.[4]

As indicated in the chart below, large-cap companies continue to be the primary focus of shareholder proposals across all categories.[5] However, this chart also reflects that shareholder proponents are beginning to move down the market cap spectrum and are increasingly targeting smaller companies.

4 For example, according to data from FactSet Shark Repellent, less than 10% of the S&P 500 have classified boards, as compared to 39% of the S&P 400 (mid-cap) and 46% of the S&P 600 (small-cap). Similarly, 86% of S&P 500 companies have majority voting in director elections, compared to 56% of the S&P 400 (mid-cap) and 28% of the S&P 600 (small-cap).

5 Data throughout this publication relates to U.S. companies and is based on information from ISS and FactSet Shark Repellent, as well as our own review of public filings.

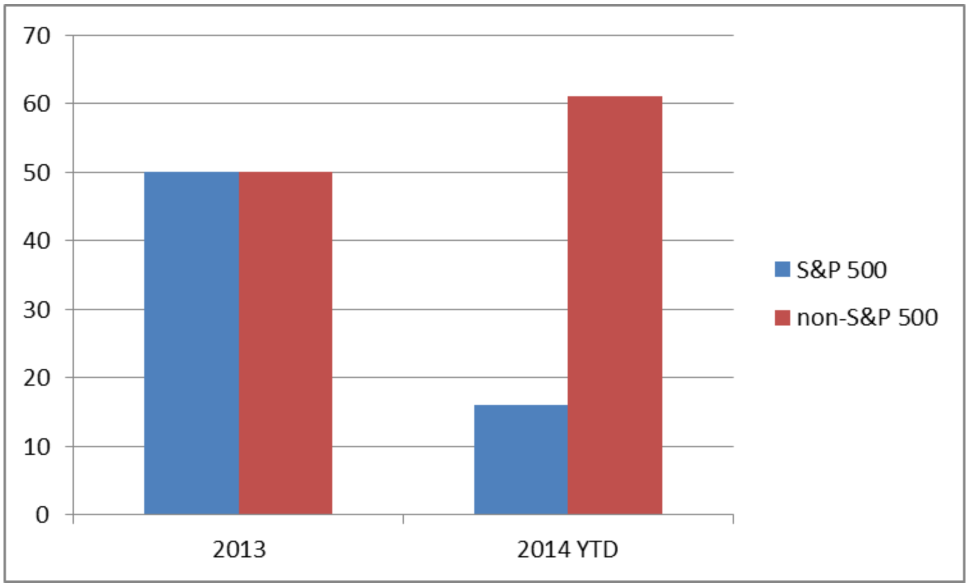
SHAREHOLDER PROPOSALS INCLUDED IN PROXY STATEMENTS (S&P 500 VS NON-S&P 500)



The absolute number of proposals included in proxy statements of non-S&P 500 companies is already slightly higher through June 2014 than it was in all of 2013. Proposals received by smaller companies in 2014 represented a higher percentage of total shareholder proposals, due largely to the lower number of proposals at large companies, as there are relatively few large companies remaining to serve as targets for destaggering, majority voting and supermajority threshold proposals.

The increased impact of shareholder proposals is actually greater than is reflected in the numbers of proposals coming to a vote. Many shareholder proposals—or threatened shareholder proposals—on the most contentious governance topics never make it to a shareholder vote, because the company determines to address the governance concern through its own proposal, thereby convincing the proponent to withdraw the proposal or allowing the company to exclude it 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. As reflected in the below chart, there has been a marked shift from 2013 to 2014 in management proposals to destagger the board, which were evenly divided in 2013 between large and smaller companies, but are dominated in 2014 by companies outside the S&P 500.

MANAGEMENT PROPOSALS TO DESTAGGER THE BOARD (S&P 500 VS NON-S&P 500)



The decrease in management proposals to destagger at large companies is consistent with the fact that less than 10% of these companies still have staggered boards. However, the increase in management destaggering proposals at smaller companies supports the view that, on the most impactful governance issues, smaller companies are increasingly in the crosshairs of governance activists. Further evidence for this shift in focus can be seen in the efforts by the California State Teachers' Retirement System, or CalSTRS, to advance the adoption of majority voting at smaller companies. In their 2013 annual report on corporate governance, CalSTRS describes their expanded engagement and shareholder proposal efforts to the Russell 2000 companies and beyond, noting that these companies have lagged beyond the S&P 500 in adopting majority voting.[6]

A more detailed discussion of governance-related proposals is set forth in the following section.

[6] *See* CalSTRS, Corporate Governance: 2013 Annual Report, at page 12-13, *available at* http://www.calstrs.com/sites/main/files/file-attachments/corporate_governance_annual_report_7-19-13.pdf.

C. SHAREHOLDER PROPOSALS ON GOVERNANCE STRUCTURE

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

	THREE PRIMARY GOVERNANCE PROPOSALS					
	Total Shareholder Proposals Voted On		*Average % of Votes Cast in Favor*		*Shareholder Proposals Passed*	
	2014	*2013*	*2014*	*2013*	*2014*	*2013*
Declassify Board	15	31	84%	79%	14	30
Adopt Majority Voting	25	33	59%	60%	15	19
Eliminate Supermajority Provisions	11	18	67%	72%	7	16

The shareholder proposals that were the most successful in 2014 are those that have been the most successful over the past decade or so—proposals that seek to bring the governance practices of companies in line with what many shareholders see as baseline practices for good governance at large public companies. These include 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).

Most large public companies have already enacted these governance changes since 2000, largely in response to shareholder pressure and evolving views of market practice. The lower number of proposals in 2014 likely just reflects the decreasing number of large companies that have resisted the pressure to adopt these changes and thus remain targets for these types of proposals.

These governance changes have been 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.[7] As discussed in Section I.B above, however, it appears from the 2014 data that smaller companies are starting to see more of these proposals, and this will likely continue in the future.

This does not mean, of course, that companies that face these proposals, or that believe they may face these proposals, should necessarily begin abandoning or watering down antitakeover protections. In making decisions on governance structure, a board of directors should act in what it believes to be the best interests of the corporation—for Delaware corporations, the business judgment rule will continue to protect directors making determinations in good faith, notwithstanding activist views or the existence of a precatory shareholder "mandate" as to governance structure. Many companies that have considered the issue continue to believe that these types of provisions ultimately work to the benefit of the company or its

7 See footnote 4 above for statistics on the prevalence of these practices at larger versus smaller companies.

shareholders by encouraging continuity and stability on the board, and better positioning the board to protect all shareholders from the use of coercive tactics by a party seeking to change control of the company.

Companies that retain these types of governance structures commonly opposed by shareholders should, however, be prepared to have the subject regularly raised by both shareholder activists and institutional shareholders on an ongoing basis. Even large institutional investors have, in recent years, been sending letters to portfolio companies raising these sorts of governance concerns, and have raised these concerns in shareholder outreach meetings (including, increasingly, at smaller companies).

In addition, directors should be aware, that if one of these governance-related proposals passes but the board does not make the recommended changes, the directors may face negative director recommendations in future years under the policies of ISS and others. ISS revised its director withhold policies at the end of 2012 in a manner that significantly changed 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 with 2014 annual meetings, 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 years before that.

In light of this ISS policy change, together with changes in market practice and ongoing pressure from shareholders, we expect that companies are giving greater consideration to adopting these governance provisions 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 allowing a shareholder proposal to come to a vote rather than taking action.

2. Independent Chair

INDEPENDENT CHAIR					
Total Shareholder Proposals Voted On		Average % of Votes Cast in Favor		Shareholder Proposals Passed	
2014	2013	2014	2013	2014	2013
60	60	31%	32%	4	6

Proposals requesting that companies separate the roles of CEO and chair[8] were, once again, the most common type of governance-related proposal by far. Sixty such proposals were voted on so far in 2014, the same number as were voted on in all of 2013, which in turn was an increase from 2012. Large companies have regularly received these proposals since the mid-2000's, apparently 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 2014, the average level of shareholder support was 31%, down from 32% in 2013 and 35% in 2012. ISS support for these proposals is also down from historical levels—ISS supported 50% of these proposals in each of 2013 and 2014 compared to 75% 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 around 40% in each of 2012, 2013 and 2014 if ISS supported the proposal, but only around 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 (particularly if the company has performed relatively well). 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 a shareholder proposal to separate the roles.

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

[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.

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]

One additional note on excludability of these proposals under SEC rules—the no-action letters issued by the SEC staff in response to Rule 14a-8 exclusion requests illustrate a relatively nuanced view as to when a proposal may be excluded for referencing an extrinsic definition of independence to define 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.[10] Consistent with this position, SEC no-action letters over the past few years 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).[11] 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,[12] or even if they merely include the phrase "independent director" without any definition at all.[13] Because the SEC staff's views on the excludability of these proposals turn on nuanced differences in the wording of the proposals, companies that receive such a proposal should consult with counsel to determine how the staff would likely come out.

3. Shareholder Right to Act by Written Consent

RIGHT TO ACT BY WRITTEN CONSENT					
Total Shareholder Proposals Voted On		*Average % of Votes Cast in Favor*		*Shareholder Proposals Passed*	
2014	*2013*	*2014*	*2013*	*2014*	*2013*
27	28	39%	41%	0	3

Companies have continued to receive a significant number of shareholder proposals requesting that the company grant shareholders the right to act by written consent—the number of these proposals voted on so far in 2014 is comparable to the number in all of 2013, and is up significantly from the 21 proposals

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.

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

11 *See, e.g., McKesson Corp.* (Apr. 17, 2013), *reconsideration denied* (May 31, 2013).

12 *See, e.g.*, *Aetna Inc.* (Mar. 1, 2013).

13 *See, e.g.*, *FirstEnergy Corp.* (Mar. 10, 2014).

voted on in 2012. However, the average vote and the number of proposals passed have continued to decline, with no proposals passing so far in 2014, compared to three in 2013 and six in 2012.

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 assert that companies should permit action by written consent on the basis that shareholder action should not be limited to the normal annual meeting cycle. The concern that companies have about giving shareholders the right to act by written consent is that the written consent process can frustrate 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, in certain instances, give shareholders the 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 next section), although this can also have a disruptive effect.

Upon receiving a written consent proposal, some companies have put forth a management proposal to adopt written consent rights, thereby allowing the company to exclude the shareholder proposal as "conflicting" under Rule 14a-8(i)(9). There have been seven such management proposals in 2014, compared to 12 in 2013 and 11 in 2012. These management proposals generally include provisions designed to reduce the potential coercive use of the process and to permit it to work in a more deliberative and organized manner, including similar timing and disclosure requirements as would apply to a shareholder meeting. Common provisions in management proposals include:

- 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 company;
- Requiring the solicitation of all shareholders;
- A delay before consents could be delivered (*e.g.*, 50 or 60 days) to ensure that shareholders have sufficient time to consider the matters subject to the consent;

- Timing limitations, such as denying the process if the request was delivered in the 90-day period prior to the anniversary of the prior annual meeting (because the company could have included a shareholder proposal in the annual meeting proxy statement), 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; and/or
- Disclosure requirements calling for the same information to be provided as is required by the advance notice bylaws.

The declining success rate of these proposals may make companies less inclined to adopt their own provision, and instead simply allow the shareholder proposal to come to a vote. However, companies that receive a written consent shareholder proposal that they believe (after consultation with their proxy solicitor) has a good chance of passing may want to consider preemptively putting forth their own proposal (and excluding the shareholder proposal as "conflicting"), because the subsequent adoption of a written consent provision with terms similar to those described above may not be seen as sufficiently "responsive" by ISS for purposes of future director recommendations. ISS's FAQs do recognize that "reasonable restrictions" on written consent rights are acceptable, but provide the following guidelines on what restrictions are considered reasonable:

- An ownership threshold of no greater than 10 percent;
- No restrictions on agenda items;
- A total review and solicitation period of no more than 90 days (to include the period of time for the company to set a record date after receiving a shareholder request to do so, and no more than 60 days from the record date for the solicitation process);
- Limits on when written consent may be used of no more than 30 days after a meeting already held or 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 be "examined in light of the disclosure by the company about its outreach to shareholders, the board's rationale, etc. on what they consider reasonable, equity structure of the company, etc."[14] 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, depending on the terms adopted and the company's disclosure on shareholder outreach. As noted in Section II.A below, ISS withhold recommendations on the basis of "non-responsiveness" seem to have a significant impact on voting results in director elections.

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[14] *See* ISS, "*Frequently Asked Questions on U.S. Proxy Voting Policies and Procedures (Excluding Compensation-Related Questions) (April 30, 2014),*" at question 45, *available at* http://www.issgovernance.com/file/2014_Policies/ISSUSFAQsPoliciesandProcedures04302014.pdf ("ISS FAQs"). ISS gives Amgen as an example of a company that put forth a management proposal at an ownership level of 15%, but was deemed responsive by ISS because of the shareholder outreach disclosure in their 2012 proxy.

4. Shareholder Right to Call Special Meetings

	RIGHT TO CALL SPECIAL MEETINGS					
	Total Shareholder Proposals Voted On		Average % of Votes Cast in Favor		Shareholder Proposals Passed	
	2014	2013	2014	2013	2014	2013
Adopt new right	6	8	48%	54%	4	5
Lower % on existing right	7	4	36%	33%	0	0

Proxy advisory firms and many shareholders support the right of shareholders to call a special meeting because this enables shareholders 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, or the amendment of bylaws). 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 an effective mechanism to provide directors with additional time to consider hostile takeover proposals and seek superior alternatives. About 60% 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 call the meeting 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 is the case with written consent proposals, some companies that have received a special meeting shareholder proposal have instead proposed their own special meeting provision, and excluded the shareholder proposal as "conflicting" under Rule 14a-8(i)(9). In fact, there have been more management proposals to adopt special meeting rights in recent years than shareholder proposals, with 18 already coming to a vote in 2014, compared to 15 in all of 2013 and 21 in all of 2012. Thus, while the overall trend toward special meeting rights among larger companies has been driven by shareholder proposals and the levels of shareholder support, the actual terms and conditions of these provisions have frequently been shaped by those included by companies in their own proposals.

Terms that companies may wish to consider including in any management proposal for a special meeting right include:

- ***Threshold.*** Though practice varies considerably, 25% has emerged as the most common threshold for special meeting rights at public companies. Both Vanguard and T. Rowe Price have indicated that 25% is an appropriate level in their view. The following table shows the threshold for special meeting rights at the 301 S&P 500 companies that are incorporated in Delaware.[15]

SPECIAL MEETING THRESHOLDS (S&P 500 DELAWARE COMPANIES)	
Ownership Threshold for Calling Meeting	***Number of Companies***
No special meeting right	153
50% or more	30
30-40%	10
25%	***70***
20%	15
15%	11
10%	12

- ***Definition of ownership.*** Many companies require "record" ownership of shares (as opposed to "beneficial" ownership), essentially requiring street name holders to work through their securities intermediaries to become a record holder. This eliminates uncertainty as to proof of ownership, but introduces an additional administrative step for shareholders seeking to use the right. In addition, a number of companies have introduced a "net long ownership" concept into their special meeting provision—essentially reducing the shareholders' actual ownership level by any short positions or other hedging of economic exposure to the shares. Companies that do not include a "net long" concept should nevertheless ensure that the information required to be provided by the requesting shareholders includes details of any hedging transactions, so that the company and other shareholders can have a full picture of the requesting shareholders' economic stake in the company.
- ***Pre- and post-meeting blackout periods.*** In order to avoid duplicative or unnecessary meetings, many companies provide that no meeting request will be valid if it is received during a specified period (usually 90 days) before the annual meeting, or during a specified period (usually 90 or 120 days) after a meeting at which a similar matter was on the agenda.
- ***Limitations of matters covered.*** Special meeting provisions typically provide that the special meeting request must specify the matter to be voted on, and that no meeting will be called if, among other things, the matter is not a proper subject for shareholder action. Generally, the only items that may be raised at the special meeting will be the items specified in the meeting request and any other matters that the board determines to include.
- ***Timing of meeting.*** Companies typically provide that the board must set the meeting for a date within 90 days from the receipt of a valid request by the requisite percentage of shareholders. Often, the special meeting provisions provide that, in lieu of calling a special meeting, the company may include the specified item in a meeting called by the company within that same time period.
- ***Holding period.*** A few companies require the requesting shareholders to have held the requisite number of shares for a specified period of time prior to the request.
- ***Inclusion in charter versus bylaws.*** Companies should consider whether to include the special meeting provisions in the charter, the bylaws, or a combination. In most cases, companies include the critical provisions (such as ownership threshold) in the charter so that shareholders cannot unilaterally amend them, but provide the details and mechanics in the bylaws, so they can be adjusted by the board without a shareholder vote.

[15] Based on data from FactSet Shark Repellent. We have limited this analysis to Delaware companies, because certain other states provide a statutory default special meeting right at 10%.

The results in the table at the beginning of this section show that adopting a special meeting right does not mean that a company will necessarily be free from future proposals on this topic. In 2013 and 2014, 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, none of these proposals passed, nor have such proposals generally passed in prior years, indicating that if a company adopts a special meeting right at a reasonable threshold 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. As with written consents, if a 10% special meeting shareholder proposal comes to a vote and passes, the adoption of a provision with the terms described above may well not be seen as "responsive" by proxy advisory firms assessing director recommendations in the following year.[16]

[16] ISS's FAQs indicate that a threshold above 10% will be deemed responsive only if the company's outreach to its shareholders finds a different threshold acceptable to them, and the company disclosed these results in its proxy statement, along with the board's rationale for the threshold chosen, and even then the analysis is case-by-case. In addition, ISS takes a limited view of the permissible restrictions on the special meeting right, including a view that restrictions on agenda items are generally seen as negating the right to call a special meeting. *See* ISS FAQs, *supra* note 14, at questions 43-44.

5. Proxy Access Proposals

PROXY ACCESS					
Total Shareholder Proposals Voted On		*Average % of Votes Cast in Favor*		*Shareholder Proposals Passed*	
2014	*2013*	*2014*	*2013*	*2014*	*2013*
10	15	34%	32%	3	4

Pursuant to SEC rule changes that took effect in 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 have since corrected these problems. However, the number of proxy access shareholder proposals submitted is down in 2014 as compared to both 2013 and 2012.

There were two forms of proxy access proposals submitted for the 2014 proxy season, one of which generally received very little support and the other of which received significant support:

SUMMARY OF 2014 PROXY ACCESS PROPOSALS

Proponent	*Threshold/ Holding Period*	*Company*	*ISS Rec.*	*Outcome*
NYC and Philadelphia Pension Funds/Other Individual Shareholders	3%/3 years	Big Lots	For	57% of votes cast
		Boston Properties	For	65% of votes cast
		Comstock Resources	For	47% of votes cast
		International Game Technology	For	58% of votes cast
		Kilroy Realty Corp.	For	47% of votes cast
		Walgreen	For	44% of votes cast
Harrington/ McRitchie (USPX form)	Either (a) holders with at least 1% but less than 5% for 2 years or (b) 25 holders of $2,000 each with at least 1% but less than 5% for 1 year	Apple	Against	4% of votes cast
		Bank of America	Against	7% of votes cast
		Citigroup	Against	6% of votes cast
		Goldman Sachs	Against	3% of votes cast

a. Precatory 3%/3-Year Proposals

Terms of Proposals. The most common, and most successful, form of proxy access proposal in 2014 is one that follows the ownership requirement of the SEC's now-vacated proxy access rule. 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 received significant levels of shareholder support—they passed three of the six times they came up for a vote, and nearly passed the other three times. ISS recommended "for" the proposal in all cases. In addition, in 2013 and 2014, a few large companies (Hewlett Packard, Western Union and Chesapeake Energy) adopted proxy access provisions at the 3%/3-year level, in each case upon having received, or having shareholders pass, a shareholder proposal at this level. These results indicate that a proposal such as this one would achieve a significant level of support at many companies that did not already have a proxy access provision.

Companies may want to think about steps to prepare for and respond to such proposals, including maintaining a dialogue with key shareholders and monitoring market trends in this area. In addition, companies may wish to consider the terms of a proxy access provision that might be acceptable to the company, or other governance enhancements that may prevent the company from becoming a proxy access target. Although there seems to be little benefit to the unilateral adoption of a proxy access provision on a preemptive basis, there may be a benefit for a company to be prepared to put its own proxy access proposal up for a shareholder vote, particularly because doing so should permit the exclusion of a conflicting shareholder proposal.[17]

b. U.S. Proxy Exchange Form of Proposal (1%/25 Holders)

Terms of Proposals. The other form of proxy access proposal this year was based on a model issued by the United States Proxy Exchange, a shareholder advocacy group. 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 25 holders who have held continuously for one year at least $2,000 of stock and collectively between 1% 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 of 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 negligible support. Despite revision of such proposals in response to negative ISS recommendations in 2012 and 2013, ISS maintained its recommendation "against" such proposals in 2014, noting the low 1% threshold, the potential for replacement of nearly half the board in a single election, and the fact that the proposal discriminates against 5% shareholders.

[17] For a detailed discussion of considerations a company may wish to address, or actions it may want to pursue, relating to potential proxy access proposals in the future, see Chapter 12 of PLI's Public Company Deskbook, *supra* note 2, authored by partners of our firm.

D. SOCIAL/POLITICAL SHAREHOLDER PROPOSALS

	SOCIAL/POLITICAL PROPOSALS					
	Total Shareholder Proposals Voted On		Average % of Votes Cast in Favor		Shareholder Proposals Passed	
	2014	2013	2014	2013	2014	2013
Political issues	81	89	24%	24%	3	2
Environmental issues	40	40	23%	15%	0	0
Human rights issues	16	16	18%	15%	0	0
Sustainability report	15	14	20%	33%	0	1
Anti-discrimination	10	11	30%	28%	0	0
Animal rights	6	6	15%	2%	1	0
Other social policy issues	10	3	13%	12%	0	0

The landscape for proposals on social and political issues was similar in 2014 to that in 2013—these proposals continue to be common, but in almost all cases they fail, and usually by a wide margin. In 2014, as in 2013, the most common type of proposal 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 significantly greater support. Three of these disclosure-based proposals passed in 2014, in each case with the support of slightly over 50% of votes cast. A large number of other disclosure-based proposals nearly passed, with support levels between 40-50%. The generally high levels of support for these types of proposals in recent years have spurred a number of companies to voluntarily expand their public disclosure regarding political and lobbying expenditures with corporate funds.

Outside of the political area, the only shareholder proposal on social issues that passed in 2014 was a *laudatory* proposal at Kraft Foods praising the company's animal rights improvement efforts. This proposal was supported by management, and got over 80% support.

ISS supported over 70% of the social and political proposals voted on in 2014, which is significantly higher than in prior years, though this likely relates more to the types of proposals submitted than any change in ISS policy. Social and political proposals had an average support level of 29% if ISS recommended in favor, and 5% if ISS recommended against.

The continued frequency of proposals on social policy issues, despite their overwhelming 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.[18]

E. COMPENSATION-RELATED SHAREHOLDER PROPOSALS

	COMPENSATION-RELATED PROPOSALS					
	Total Shareholder Proposals Voted On		*Average % of Votes Cast in Favor*		*Shareholder Proposals Passed*	
	2014	*2013*	*2014*	*2013*	*2014*	*2013*
Stock retention	25	36	23%	24%	0	0
Limit golden parachutes	21	33	37%	34%	5	0
Link pay and performance	2	5	18%	31%	0	0
SERP-related	2	3	36%	30%	0	0
Limit death benefits	1	2	35%	38%	0	0
Other compensation-related	7	15	15%	17%	0	1

Compensation-related proposals continue to be predominantly of two types: proposals to prohibit “golden parachutes” in the form of single-trigger accelerated vesting of performance and other equity awards and proposals seeking stock retention requirements for executives (typically extending beyond retirement). 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.

The most notable change for 2014 is that, for the first time, a significant number of “golden parachute” proposals actually received the support of a majority of votes cast—five such proposals passed in 2014, compared to zero in 2013 and 2012. This was despite a significant drop in the total number of such proposals from 2013 to 2014. Shareholder proponents appeared to do a better job of targeting these proposals at companies where concerns over these practices were shared by shareholders more broadly. An increasing number of companies have begun including “double-trigger” termination provisions (*i.e.*, those that accelerate outstanding awards only if a change in control occurs *and* the person is terminated) into their compensation arrangement, which should help a company avoid or defeat a “golden parachute” shareholder proposal.

18 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, 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.

ISS supported nearly 90% of the compensation-related proposals in 2014, and shareholder support averaged 31% for proposals where ISS recommended in favor, as compared to 5% for proposals where ISS recommended against.

F. RECENT LITIGATION DEVELOPMENTS CONCERNING RULE 14A-8

The most common avenue, by far, for attempting to apply the exclusion criteria of Rule 14a-8 to shareholder proposals has been the SEC staff no-action process. However, in recent years, a number of companies have turned to the U.S. Federal courts regarding the application of Rule 14a-8, presumably in situations where they did not have sufficient confidence that the SEC staff would agree with the company's interpretation of the rule.

Such an approach is not at odds with the SEC's views of its authority. The SEC staff has expressly confirmed that "the staff's no-action responses to Rule 14a-8(j) submissions reflect only informal views. The determinations reached in these no-action letters do not and cannot adjudicate the merits of a company's position with respect to the proposal. Only a court such as a U.S. District Court can decide whether a company is obligated to include shareholder proposals in its proxy materials."[19]

Several corporations have recently sought declaratory relief from Federal courts regarding the exclusion of shareholder proposals, with mixed results. As described further below, although some Federal courts have permitted exclusion where the SEC staff might not have, companies have in many cases failed to convince courts that they have subject matter jurisdiction to make such a determination.

1. Earlier Fifth Circuit Victories for Corporations

One prominent success for a corporate plaintiff occurred in a 2010 case, *Apache Corp.* v. *Chevedden*,[20] in which the U.S. District Court for the Southern District of Texas granted the company's motion for declaratory judgment, finding that the shareholder proponent, John Chevedden, failed to meet the stock ownership requirements of Rule 14a-8(b) under the Securities Exchange Act of 1934. This was followed by another corporate victory in 2011 in the same district court. In *KBR Inc.* v. *Chevedden*,[21] the U.S. District Court for the Southern District of Texas (in a decision affirmed by the Fifth Circuit) again concluded that Mr. Chevedden's proof of ownership was inadequate. The court in KBR, however, also addressed the issue of standing, holding that the exclusion of a shareholder proposal presented an "actual controversy" because, even though Mr. Chevedden made an irrevocable promise not to sue, his refusal to withdraw indicated a willingness to enforce his rights and to continue to litigate the dispute.

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19 *See* SEC Division of Corporation Finance, Informal Procedures Regarding Shareholder Proposals, *available at* http://www.sec.gov/divisions/corpfin/cf-noaction/14a-8-informal-procedures.htm.

20 696 F. Supp. 2d 723 (S.D. Tex. 2010).

21 2011 WL 1463611 (S.D. Tex.), *aff'd* 478 Fed. Appx. 213 (5th Cir. 2012).

Similarly, in February 2014, in *Waste Connections Inc.* v. *Chevedden*,[22] the Fifth Circuit granted declaratory relief to Waste Connections permitting it to exclude a shareholder proposal. Although Mr. Chevedden and other proponents pointed out that they had given Waste Connections an irrevocable promise not to sue, the court (quoting *KBR*) pointed out that Waste Connections faced a choice between spending a significant sum to revise its proxy statement or excluding Chevedden's proposal and exposing itself to potential litigation. The court stated that the corporation's decision to revise its proxy statement or exclude the proposal would implicate the corporation's duties to all its shareholders and that wrongfully excluding the proposal could expose Waste Connections to an SEC enforcement action.[23]

One recent corporate victory occurred outside the Fifth Circuit, but did not include significant discussion of the standing issue. In February 2014, in *Express Scripts* v. *Chevedden*,[24] the U.S. District Court for the Eastern District of Missouri granted Express Scripts declaratory relief (citing *Apache*, *KBR* and *Waste Connections*) and permitted it to exclude Mr. Chevedden's proposal under Rules 14a-8 and 14a-9, on the grounds that the supporting statement contained material misstatements (specifically, inaccurate assertions that the company did not have a clawback policy or majority voting, and inaccurate statements of the CEO's compensation amount and the director voting results in the prior year). By contrast, a request for no-action relief from the SEC staff for the same proposal may well have produced a contrary result, given the staff's limited history of allowing excludability on this basis.

2. More Recent Losses for Corporations Outside the Fifth Circuit

A number of decisions this year, however, call into question the viability of the Federal courts as an avenue for excluding Rule 14a-8 proposals. Thus far in 2014, Federal courts have found that they did not have subject matter jurisdiction to determine whether corporations could validly exclude a shareholder proposal in at least three cases, each of which involved a proposal from Mr. Chevedden. In *EMC Corp.* v. *Chevedden*,[25] EMC sought declaratory relief permitting it to exclude a proposal on the grounds that the proponents had not met share ownership requirements for filing the proposal. In March 2014, the U.S. District Court for the District of Massachusetts held that EMC had failed to show the existence of a "case or controversy" required by Article III of the U.S. Constitution for a Federal court to assert jurisdiction.

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22 554 Fed. Appx. 334, [2013-2014 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,819 (5th Cir. 2014).

23 In the *Waste Connections* decision that was on appeal, the district court had permitted the company to exclude Mr. Chevedden's proposal from its proxy materials under Rule 14a–8 on various grounds, including that Rule 14a-8 does not permit a shareholder to grant a proxy to another to submit a shareholder proposal. No. 4:13–cv–00176 (S.D. Tex. June 3, 2013). Interestingly, this decision was cited by a number of companies, including Apple, in no-action letters to the SEC staff attempting to exclude proposals under similar circumstances, but the staff (without explanation) seemed to decline to apply the reasoning of the decision. *See Apple, Inc.* (Dec. 17, 2013).

24 2014 WL 631538, [2013-2014 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,823 (E.D. Mo. 2014).

25 2014 WL 1004111, [2013-2014 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,860 (D. Mass. 2014).

The court found that EMC lacked standing because it had not demonstrated that there would be an "imminent injury in fact" in the absence of a declaratory judgment—the court noted that the proponents had made an irrevocable promise not to file suit against EMC or raise the proposal at EMC's annual meeting if the proposal were excluded from EMC's proxy materials. The court also rejected EMC's argument that it faced a substantial risk of an action by the SEC or other shareholders because EMC had not submitted any evidence showing the existence of such risk and had not rebutted statements by the proponents as to the rarity of enforcement actions by the SEC. The court also observed that a declaratory judgment would not bar actions by the SEC or a third party because such parties would not be collaterally estopped by the judgment.

Similar decisions were issued later in March 2014 by the U.S. District Court for the Southern District of New York in *Omnicom Group* v. *Chevedden*[26] and by the U.S. District Court for the District of Colorado in *Chipotle Mexican Grill* v. *Chevedden*.[27]

The decisions in *Waste Connections* and *KBR* were expressly considered, but not followed, by the *EMC* and *Chipotle* courts. The *EMC* court stated that it found the Fifth Circuit's reasoning in *Waste Connections* unpersuasive and noted that the Fifth Circuit had not recognized that a declaratory judgment permitting exclusion would not, as a matter of law, address the corporation's alleged harm or risk of litigation by the SEC or other shareholders.[28] The *Chipotle* court additionally noted that the Fifth Circuit had not applied the "certainly impending" standard to assess the risk of injury in *KBR* or *Waste Connections* and stated that it found the reasoning in *EMC* and *Omnicom* "more persuasive."[29]

3. Choosing Between the Federal Courts and the No-Action Process

As a result of the decisions in *EMC*, *Omnicom* and *Chipotle*, corporations seeking declaratory relief from Federal courts outside the jurisdiction of the Fifth Circuit face a substantial risk of having their actions dismissed for lack of subject-matter jurisdiction, particularly where proponents have given irrevocable undertakings not to sue if their proposals are seen as creating a sufficiently immediate risk of injury to justify the grant of declaratory relief. However, the denial of no-action relief by the SEC staff may serve to give weight to the "remote" threat of enforcement actions by the SEC which was dismissed by the *EMC*, *Omnicom* and *Chipotle* courts and such denials may therefore support a corporation's claim for relief in a Federal court.

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26 2014 WL 969801 (S.D.N.Y.).

27 [2013-2014 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,858 (D. Colo. 2014).

28 *EMC,* [2013-2014 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,860, at 91,240.

29 *Chipotle*, [2013-2014 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 97,858, at 91,229.

The *EMC* and *Chipotle* decisions appear to endorse the choice of the SEC as the appropriate initial forum in which to decide whether a shareholder proposal should be permitted to be excluded. As the *Chipotle* Court observed, "where Plaintiff has not presented its case to the SEC, this Court's issuance of a declaratory judgment on an expedited basis 'would be essentially reversing the statutory scheme and not be in the interests of the administration of justice.'"[30] The *EMC* court went further, stating that "a declaratory judgment would abet an inappropriate practice by encouraging companies to fail to present their arguments first to the SEC to provide it an opportunity to perform its intended role as a source of expeditious, expert advice…issuing a declaratory judgment would encourage end runs around the SEC, which would deprive shareholders of an inexpensive opportunity to have disputes resolved in their favor."[31] For this reason, corporations may find it prudent (at least, outside the jurisdiction of the Fifth Circuit) to exhaust the SEC no-action process before seeking relief in the Federal courts.

II. ANALYSIS OF ISS NEGATIVE RECOMMENDATIONS AGAINST DIRECTORS

The widespread adoption of majority voting provisions, along with NYSE rule changes in 2009 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. "Withhold" or "against" 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.[32] For companies that have majority voting provisions, 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), raise the company's profile as a target for shareholder activists, 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. In 2014, ISS issued negative recommendations against approximately 3,000 directors in total, at over 1,000 different companies. Of these directors, only around 1% (less than 40) received more

30 *Id*. (quoting *EMC).*

31 *EMC* at *9.

32 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 publication, we refer to both types of votes as "negative" votes on the director or "votes against" the director.

"against" votes than "for" votes in 2014. Most of these directors were at small- or mid-cap companies—only three directors at S&P 500 companies received more "against" votes than "for" votes.

The following table summarizes the frequency of negative recommendations, the resulting shareholder vote, and the number of directors receiving less-than-majority support during 2014 for all U.S. public companies, broken down by the rationale given by ISS for the negative recommendation:[33]

	2014 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***
Excessive non-audit fees paid to auditors, or failure to disclose a breakdown of fees	771	93%	0
Independence issues (non-independent directors on key committees or failure to maintain a majority independent board)	768	89%	5
Absence of a formal nominating or compensation committee	652	90%	5
Poison pill issues (*e.g.*, maintaining a pill with dead-hand provisions or failing to put a pill up for a shareholder vote)	172	77%	5
Poor attendance at board and committee meetings (<75%)	113	85%	2
Compensation issues	96	84%	2
Lack of responsiveness to shareholder concerns (*e.g.*, failure to implement a successful shareholder proposal)	95	70%	17
Failure to address material weakness in internal controls	82	87%	0
Taking unilateral action that reduces shareholder rights	74	82%	1
Failure of risk oversight due to pledging of shares by executives	43	90%	0
Failure to opt out of amendment to Indiana law resulting in classified board	37	86%	0
Overboarding	26	82%	1

A. BOARD RESPONSIVENESS TO SHAREHOLDERS

The most notable development in 2014 in terms of ISS director withhold recommendations is the increased number of recommendations based on a perceived lack of responsiveness to shareholder

[33] Based on our analysis of data provided to us by ISS, supplemented by a review of publicly available information. This table omits recommendations for which no rationale was included in the data provided by ISS. In addition, there is some overlap in the categories, because some directors received negative recommendations for more than one reason.

concerns—typically, if the board has failed to act on a successful shareholder proposal from a prior year or failed to address the underlying issue that led to a director receiving a majority "against" vote. Although this is far from the most common reason for a negative recommendation, it is clearly the most impactful. Shareholders as a group seem to take this issue particularly seriously—directors in this category received the support of an average of only 70% of votes cast (the lowest of any category), and were by far the most likely to receive less-than-majority support of votes cast.[34] About half of all directors that had less-than-majority support in 2014 had negative ISS recommendations due to a perceived lack of responsiveness to shareholder concerns.

This was the most impactful type of recommendation in prior years as well, but these recommendations were much more common in 2014 than in 2013. This is undoubtedly due to a change in ISS's policy with regard to board responsiveness. 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 all incumbent directors for failure to implement a proposal that received a majority of *votes cast* in a single year. Previously, ISS recommended negative votes only if the board failed to act on a shareholder proposal that was supported by a majority of *shares outstanding* in the prior year, or that was supported by a majority of *votes cast* in two of the last three years.

The significant impact of negative recommendations for this reason in 2014 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, including taking into account the considerations discussed in Section I.C above with respect to potential management proposals in lieu of allowing a shareholder proposal to pass.

B. BOARD INDEPENDENCE

A very common rationale for a negative ISS recommendation against a director (the most common, in fact, at large companies) 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 or if the board is not made up of a majority of independent directors under the ISS "independence" standards (which are, in some circumstances, more stringent than the company's own independence policies under stock exchange rules).

Directors in this category received average shareholder support of 89% of votes cast, and relatively few directors who were in this category received less-than-majority support. This suggests that shareholders broadly do not view a violation of ISS's strict independence standards as a significant concern.

[34] As discussed in Section II.E below, negative recommendations based on a perceived lack of responsiveness to prior year say-on-pay votes are even more impactful.

That said, given the varying independence definitions used by proxy advisory firms and certain institutional investors, 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.

C. AUDITOR FEE ISSUES

The most common reason for an ISS negative recommendation in 2014 was the payment of high levels of non-audit fees to the company's independent auditors[35] or (as was more often the case) the failure to disclose a breakdown of fees to enable ISS to make this evaluation. These recommendations primarily came at smaller companies that may not have focused as closely on the disclosure in this context. A negative recommendation for this reason, however, seemed to have a limited effect on voting results—directors in this category averaged support levels of 93%.

D. LACK OF FORMAL NOMINATING AND COMPENSATION COMMITTEES

Another common basis for a negative recommendation at smaller companies is the absence of a formal nominating or compensation committee. Under ISS's policies, this will trigger a negative recommendation for all non-independent directors, even if these responsibilities are undertaken by the independent directors as a group, as has been permitted for listed companies under Nasdaq rules (though, effective in 2014, Nasdaq rules 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 2014, 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, five directors with less-than-majority support in this category.

E. 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-

35 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.

related reasons in 2014 were either at companies that did not have a say-on-pay vote in 2014 (because they are on a biennial or triennial cycle) or at companies where ISS deemed the compensation oversight concern to be "egregious."

Approximately 40% of the companies that had a director with a negative ISS recommendation in 2014 for compensation-related reasons were in the first category—that is, they did not have a say-on-pay vote in 2014 and, therefore, ISS directed its 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 60% of companies where directors received negative ISS recommendations in 2014 for compensation-related reasons did have a say-on-pay vote in 2014, 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 2013 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 its negative recommendation against the director (*e.g.*, excise tax gross-ups, repricing or acceleration of options, single-trigger change-in control rights or ongoing pay for performance disconnects).

The average level of shareholder support for directors receiving negative ISS recommendations for compensation-related reasons was 84% of votes cast. This breaks down as follows based on the categories discussed above:

- an average of 88% of votes cast where the company did not have a say-on-pay vote in 2014, and therefore ISS directed its compensation-related concerns toward director withhold nominations;
- an average of 87% of votes cast where the company did have a 2014 say-on-pay vote, but ISS nevertheless identified idiosyncratic problematic compensation decisions or practices that warranted a negative recommendation on directors; and
- most notably, an average of 57% where the company received less than 70% on its prior year say-on-pay vote and was not seen by ISS as having taken sufficient responsive action.

These results reflect the importance for companies that had low say-on-pay results to focus their efforts on engaging in shareholder outreach efforts, and disclosing these outreach efforts and any resulting compensation changes, to demonstrate appropriate responsiveness in the following year.

F. POISON PILL ISSUES

Another relatively impactful reason for a negative recommendation in 2014 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, or renews an existing poison pill, without shareholder approval; or
- the board makes a material adverse change to an existing poison pill without shareholder approval.

Shareholders generally tended to follow ISS's recommendation in this situation more than in other situations—directors receiving negative recommendations for this reason had average voter support of only 77%, the second lowest of all categories.

G. 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.

H. PLEDGING BY INSIDERS

2014 was the second year under ISS's new policy under which any amount of hedging or the significant pledging of stock by directors or executives will be viewed as a "failure of risk oversight" that can lead to recommendations against some or all directors. ISS's FAQs clarify that "whether pledged securities were 'significant' for director recommendation purposes is determined by measuring the aggregate pledged shares in terms of common shares outstanding or market value or trading volume."[36]

ISS does not provide a bright line percentage that will be considered "significant" for these purposes. However, based on our review of the relevant proxy statements, these ISS negative recommendations were made at companies where the amount of stock pledged by insiders ranged from 7% to 44% of the stock outstanding.

A total of 43 directors received negative recommendations in 2014 due to pledging by insiders. Voting results for these directors averaged 90%, and none received less-than-majority support. No directors received negative recommendations due to hedging by insiders (due, perhaps, to the fact that, unlike pledging, there is no proxy requirement to disclose specific hedging arrangements by insiders).

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[36] *See* ISS FAQs, *supra* note 14, at question 30. ISS also notes, however, that it deems *any* pledging of stock by an insider not to be a responsible use of company equity. Any amount of pledged stock by a director or officer will be a negative factor in the company's corporate governance rating under ISS's QuickScore rating system.

III. SAY-ON-PAY VOTES

A. COMPANIES, PARTICULARLY LARGE-CAP COMPANIES, IMPROVE MODESTLY ON SAY-ON-PAY RESULTS

2014 was the fourth year of say-on-pay votes under SEC Rule 14a-21(a), which was adopted in 2011 to implement Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The following table summarizes the 2013 and 2014 say-on-pay voting results:[37]

	All U.S. Companies		*S&P 500*	
	2014	*2013*	*2014*	*2013*
Average support for all issuers (for/for+against)	92%	92%	92%	91%
Percent of issuers receiving a negative ISS recommendation	11%	11%	8%	10%
Average support with ISS positive recommendation	95%	94%	95%	94%
Average support with ISS negative recommendation	68%	69%	68%	63%
Votes failed (<50% support of votes cast) [38]	1.7%	1.8%	1.0%	0.9%
Votes with <70% support of votes cast	6.5%	7.4%	4.5%	7.2%

U.S. companies, broadly speaking, had slightly better results on say-on-pay votes in 2014 as compared to 2013, continuing a trend we've seen over the past few years. 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 in 2014—that is, a lower rate of ISS negative recommendations and greater success in receiving at least 70% of votes cast.

[37] 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 13, 2014. As of that date, 398 U.S. S&P 500 companies and approximately 2,500 U.S. companies overall had held a say-on-pay vote in 2014.

[38] 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 recommendations for those directors in the following year due to "non-responsiveness." See Sections II.A and II.E above for a discussion of negative recommendations for directors under these circumstances.

There continues to be significant year-over-year turnover in failed votes—of the four S&P 500 companies that have failed their say-on-pay votes so far in 2014, all had successful votes in 2013, generally by wide margins. Of the four S&P 500 companies that had failed say-on-pay votes in 2013, two have had their 2014 vote to date, and both received majority shareholder support (over 95% support, in one case).

The generally low rate of negative results is largely a result of the efforts that companies, particularly larger companies, have made to engage with shareholders, understand their concerns, and address 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 have 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. Increasingly, these off-season communications serve to facilitate discussion on topics other than compensation as well.

This shareholder outreach takes 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, primarily to listen. Companies with largely retail shareholder bases, of course, necessarily must engage in much of these outreach efforts through their ongoing public disclosure.

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.

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[39] and Glass Lewis[40] post their engagement policies on their websites. The policies of both firms restrict their ability to engage with companies during the solicitation period for the annual meeting, which means broader discussions with these firms can occur in the off-season.

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

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

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.[41] However, an analysis of ISS's 2014 negative recommendations for S&P 500 companies suggests that, as in 2012 and 2013, 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 Compensation Table in the proxy statement) with total shareholder return in relation to the ISS-determined peer group.[42]

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 2014:

41 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.

42 See Section III.C.3 below for a discussion of the comparability issues that can arise from the use of the Summary Compensation Table numbers and the ISS peer group construction.

	U.S. S&P 500 Companies with Negative ISS Recommendations
Total	33
Number that had “high concern” on:	
• Pay-for-Performance	30
• Compensation Committee Communication and Effectiveness	6
• Severance/Change-in-Control Arrangements	5
• Non-Performance-Based Pay Elements	2
• Peer Group Benchmarking	1

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. A more detailed discussion of ISS’s pay-for-performance policies and how they were applied in 2014 follows.

C. ISS PAY-FOR-PERFORMANCE ANALYSIS

Beginning with the 2012 proxy season, ISS adopted and published 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 2014, with one exception: when evaluating relative alignment of CEO pay, ISS now focuses on three-year total shareholder return (“TSR”), rather than a combination of one- and three-year TSR.[43] ISS’s assessment methodology begins with a 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.”[44]

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 (Three-Year Period).*** 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,[45] to those of a peer group. The relative alignment metric looks at the difference between (a) the

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43 ISS has made other minor changes to its say-on-pay methodology since 2012. In 2013, it modified its peer group selection to align more closely with company-selected peer groups and added “realizable” pay (as compared to grant date pay) as a new qualitative factor. Technical information and guidance on ISS’s say-on-pay methodology is available on the ISS website at http://www.issgovernance.com/policy-gateway/2014-policy-information/. See our publication, ISS Proposes Limited Updates to 2014 Voting Policy, dated October 23, 2013, for a discussion of ISS’s 2014 policy changes.

44 See ISS’s U.S. 2014 Compensation Policy Update FAQs at http://www.issgovernance.com/file/2014_Policies/ISSUSCompensationFAQs03282014.pdf.

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

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.[46] The company's score is based on this difference calculated on a three-year basis (as opposed to a weighted one- and three-year basis, as was the case in prior years). 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 Period).*** 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 Period).*** 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.

2. 2014 Results of ISS Quantitative Analysis

The following table summarizes the outcome of these quantitative tests for the 33 U.S. S&P 500 companies that received a negative ISS recommendation on say-on-pay in 2014:

	U.S. S&P 500 Companies with Negative ISS Recommendations
Number that had "high concern" on pay-for-performance overall	30
Number that had "high concern" on the:	
• Relative Alignment of CEO Pay and TSR (3-year)	24
• Relative CEO Pay to Peer Group Median (1-year)	6
• Absolute Alignment of CEO Pay and TSR (5-year)	0

As the table indicates, most large companies that received negative ISS recommendations had a "high concern" on the three-year alignment of CEO pay and TSR versus peer groups. In contrast, the one-year relative CEO pay test yielded a "high concern" at only a small minority of these companies, and the five-year absolute alignment test produced no "high concerns" whatsoever among this group. 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.

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

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. In addition, the below concerns are often the focus of companies' supplemental proxy materials following a negative recommendation, as discussed in Section III.E below.

a. 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 in 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 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.

b. Use of TSR over Fixed Periods

The formulaic use of 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. While the elimination of one-year TSR as an element of the ISS analysis should reduce the impact of short-term changes, 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.

c. 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 beginning 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 2014 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.[47]

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, such as a new CEO or anomalous equity grant practices.

Based on our review of the narrative in the relevant ISS reports, the qualitative factor that most commonly contributed to the negative recommendation for U.S. S&P 500 companies in 2014 was the failure of incentive compensation to be rigorously performance-based. This concern was discussed by ISS at 24 of the 33 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 the following categories:

- ***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. Just over half of the S&P 500 companies receiving negative recommendations were faulted for lowering performance standards or rewarding mediocre performance with high compensation. Related to this concern, ISS listed the existence of payouts that exceeded the company's target in nine of the 33 cases. ISS viewed these above-target payouts as suggestive of weak performance standards, or, at least, the need for the company to closely examine its performance standards.
- ***The use of time-based awards rather than performance-based awards*****.** ISS identified this concern at one-third of 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.

[47] 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/.

- ***Use of subjective criteria for determining compensation.*** ISS cited the existence of subjective criteria for the determination of a bonus or the ability to use discretion to increase an executive's bonus as a negative factor in 10 of the 33 companies. ISS viewed companies using these discretionary measures as excusing poor performance. While ISS did cite these provisions with approval when companies elected to use this discretion to reduce the size of an award, these cases were rare and ISS largely viewed discretion as suspect.

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 2014 involved the payment of excise tax gross-ups. ISS mentioned this as a factor influencing its recommendation in 14 of the 33 S&P 500 companies that received negative say-on-pay recommendations.

Other concerns that ISS had at particular companies were severance or change-in-control arrangements that were not in shareholder interests, insufficient compensation committee communication and effectiveness, 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 and/or Glass Lewis vote recommendations regarding their 2014 say-on-pay proposals filed supplemental proxy materials to communicate to shareholders their disagreement with the proxy advisory firm's assessment.[48] In some cases these supplemental filings are very detailed, point-by-point rebuttals of the ISS or Glass Lewis analysis, including pointed criticisms of the application of the proxy advisory firm's tests, further explanation of the compensation committee's rationale for particular decisions, and alternative measures that show pay aligned with performance. In prior years, many of these supplemental materials criticized ISS's peer group selection, but the 2013 policy changes discussed above seem to have significantly reduced that particular problem.

These supplemental filings serve the important purpose of educating shareholders and encouraging a thoughtful consideration of the issues, and can function as a presentation deck for one-on-one discussions with significant investors. In addition, 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 or Glass Lewis recommendation and vote with management.

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48 S&P 500 companies that filed supplemental materials in 2014 regarding negative say-on-pay recommendations included AFLAC, Broadcom, CVS Caremark, CONSOL Energy, Entergy, Morgan Stanley, Republic Services, Staples and Wal-Mart.

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 use by shareholder activists of Edgar filings 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 or otherwise express their views on an upcoming vote, 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.

The expanded use of these filings began in 2012. In 2011, only 24 companies received these filings, but that number doubled in 2012 and 2013. To date in 2014, 38 different companies have received these filings. 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.[49]

Small shareholders 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.

[49] 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."

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 company 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 company at all. Broadridge Financial Solutions, the company that manages the proxy process for the vast majority of companies, 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 company.[50] 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

Beginning in 2012, a number of shareholder proponents 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 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

[50] Until 2013, 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 stopped this practice upon determining that it did not have authority to disseminate this information under its agreements with issuers and brokers.

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.

D. SEC STAFF GUIDANCE ON USE OF TWEETS IN PROXY CONTESTS

Another recent development in the area of proxy-related communications is the guidance published in April 2014 by the SEC staff facilitating the use of social media in proxy contests, as well as business combination transactions, tender offers and securities offerings. The SEC staff's interpretations allow the use of active hyperlinks to satisfy legend requirements in social media communications if necessary in light of the social media platform's limitations on the number of characters or amount of text that may be included in a communication (as is the case, most notably, with Twitter). Because the legending requirement with respect to proxy contests, consent solicitations and tender offers can apply not only to issuers but to any soliciting party, this guidance can be expected to enhance the use of social media as a tool for activist investors engaging in these efforts.[51]

Together, these developments demonstrate that shareholder activists 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.[52]

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[51] The SEC staff guidance is set forth on the SEC's website at http://www.sec.gov/divisions/corpfin/guidance/securitiesactrules-interps.htm (Questions 110.01, 110.02, 164.02, 232.15 and 232.16). See our publication, Tweets Allowed in Proxy Contests and Securities Offerings, dated April 25, 2014, for a detailed discussion of this guidance.

[52] 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.

ABOUT SULLIVAN & CROMWELL LLP

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