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Preparing for the 2013 Proxy Season

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Background

- In January 2011, the SEC adopted Rule 14a-21 to implement Section 951 of the Dodd-Frank Act, which requires issuers to hold a separate non-binding shareholder say-on pay vote to approve or disapprove compensation of named executive officers, along with a non-binding shareholder vote on whether say-on pay votes should occur every 1, 2 or 3 years (say-on-pay frequency)
- 2012 was the second proxy season in which public companies in the US had to give stockholders a say-on-pay “advisory” vote, assuming the companies adopted an annual frequency for say-on-pay

Background (Cont'd.)

- Experience of companies from both the 2011 and 2012 proxy seasons provides some helpful lessons and insights that can be instructive for companies making compensation and governance determinations in order to better position them for 2013 proxy season and future say-on-pay votes

Say-On-Pay Vote

- Vote relates to approval of compensation of “named executive officers” (i.e., named in proxy compensation tables) generally as disclosed in the proxy statement, but not individual elements of compensation or corporate practice
- Vote on say-on-pay must happen at least every three years, and frequency on say-on-pay at least once every six years
- Vote results must be disclosed within four business days of stockholders meeting on Form 8-K
- Nature of vote is “advisory” so cannot compel companies to do anything (although effect of significant stockholder disapproval, as well as ISS negative recommendations, will get companies’ attention)
- Item 402(b) of Reg. S-K requires companies to disclose in their CD&A whether they considered the results of the most recent stockholder say-on-pay vote and, if so, how that consideration affected executive compensation decisions and policies

2012 Voting Results

- Voting results of 2012 votes compared with 2011 (Russell 3000 Index):
  - Only about 2.6% of companies failed to get majority approval, compared with approximately 1% in 2011;
  - 72% obtained 90%+ approval in 2012, consistent with 2011; and
  - 91% obtained 70%+ approval in 2012, slightly down from 93% in 2011.
- Results suggest that shareholders, although not more likely to vote against say-on-pay generally, are refining their analysis of compensation practices and financial performance and focusing negative votes on particular companies with problematic pay practices

Communicating with Shareholders

- Say-on-pay was enacted largely as a result of the disconnect between company executives and shareholders and excessive salaries, or what components the salaries are based upon (time-based vs. performance based awards)
- Say-on-pay has promoted companies' communication with stockholders to convey important elements of compensation policy to stockholders and get stockholder input
- Say-on-pay has heightened importance of such communications in view of potential negative recommendations by proxy advisers
- Key—Regular communication with stockholders throughout the fiscal year

Impact of ISS Recommendations

- 2012 voting results—ISS recommendations a significant factor in say-on-pay results
  - For companies receiving a negative ISS recommendation, over 20% failed say-on-pay votes, compared with the 2.6% overall average of all companies
  - Even for companies receiving passing votes following a negative ISS recommendation, average stockholder support has been 65% vs. 95% of companies with a positive ISS recommendation

ISS Methodology

- ISS will generally recommend a vote against a company's say-on-pay proposals if any of the following is true:
  - Significant misalignment between CEO compensation and company performance (pay-for-performance)
  - Maintaining significant problematic pay practices
  - Poor communication and responsiveness

ISS Pay-for-Performance Review and Metrics

- Pay-for-Performance was the most widely addressed factor when ISS issued a negative recommendation
- For 2012, consideration of ISS-determined peer group—included 14 to 24 companies that have a size (based on assets and revenues) and market capitalization within a specified range of the company
- Quantitative Assessment
  - Relative alignment of CEO pay and total shareholder return (TSR) to those of an ISS-selected peer group
  - Relative CEO pay to Peer Group median (may trigger a "high concern" from ISS if greater than 2.33X peer)
  - Absolute alignment of CEO pay vs. total shareholder return (TSR) over a 5-year period; If CEO pay exceeds TSR by more than 30%, then a "high concern" may be issued
  - If the quantitative factors discussed above results in a "high concern", the ISS also considers various qualitative factors before deciding upon a final vote recommendation

Issuer Challenges to ISS Say-on-Pay Recommendations

- 2012 was the first year in which ISS applied its pay-for-performance policies, which was the most significant factor when issuing a negative recommendation
  - 37 companies receiving negative ISS recommendations filed supplemental proxy materials to communicate to stockholders their disagreements with ISS' assessment of compensation, as well as communicating directly with ISS
  - Of the 37 companies filing supplemental proxy information, only 5 failed their say-on-pay-advisory votes
  - Supplemental filings may not be a direct correlation in obtaining say-on-pay approval, but suggests that at a minimum, ISS recommendations have resulted in companies having to reach out to shareholders to explain compensation structure; also may serve as documentation to support investor's decision to vote with management

Communicating with Stockholders

- Say-on-pay has promoted companies' communication with stockholders to convey important elements of compensation policy to stockholders and get stockholder input
- Say-on-pay has heightened importance of such communications in view of potential negative recommendations by proxy advisers
- Importance of significant and proactive outreach to stockholders throughout the year to gain support for company's compensation philosophy, help overcome negative recommendations, including through supplemental proxy filings, and to align interests of management and stockholders

Effective Disclosure in Proxy Statement

- Use CD&A to "tell the story" about compensation decisions and rationale; avoid boilerplate descriptions
- Use of "layered" narrative, highlighting critical aspects of compensation and pay-performance early in CD&A
- Say-on-pay has increased the importance of using executive summaries
- Say-on-pay has increased importance of highlighting pay-for-performance relationship and companies are using graphs and charts to communicate the message more effectively
  - Using proxy summaries for better overview and comparisons re. pay/performance
  - Including total stockholder return (TSR) vs. CEO pay
  - Utilizing proxy performance graphs and variations thereof to address TSR
  - Consider utilizing graphs displaying pay and performance based on measures such as revenue and earnings per share growth

Considerations for 2013

- Highlighting link between pay and performance; No SEC rules yet
- Reducing nonperformance-based pay/enhancing alignment between executive compensation and stockholders
- Proactive communications and outreach to substantial stockholders throughout the year
- Using disclosure to effectively communicate with stockholders in order to receive a favorable say-on-pay vote
  - Consider past year's approval level and focus on appropriate response to take
  - ISS will scrutinize company's responsiveness to stockholder concerns of companies obtaining less than 70% stockholder support on say-on-pay vote
  - Address in detail how the company has considered the results of the most recent say-on-pay vote in determining compensation policies and decisions

Considerations for 2013 (Cont'd.)

- Meaningful and transparent disclosure
  - Clearly state targets for performance-based compensation, the actual performance and payout based on the performance
  - Include supplemental compensation tables that further provide explanation of compensation issues and how performance targets were met
  - Provide a clear rationale for inclusion of peer group companies

Lawsuits Arising from Negative Say-On-Pay Votes

- Over 20 lawsuits have been filed following negative say-on-pay votes
  - These lawsuits have received a lot of publicity
- Awareness of the litigation risk may have motivated more strenuous responses to negative ISS recommendations
- In addition there have been some 162(m)-based lawsuits relating to pay for performance

Litigation Fact Pattern Allegations

- Pay not connected to performance despite pay for performance disclosures
- Negative vote on say-on-pay
- Company did not change compensation following vote

Claims Raised by Litigation

- Directors breached duty of care and loyalty
- Misrepresentation in the proxy statement
- Corporate waste
- Consultants aided/abetted and/or breached contract
- Executives unjustly enriched

Risks from Litigation

- Generally, a consensus is emerging that directors acting in good faith will be subject to the business judgment rule
- Dodd-Frank expressly provided that the say-on-pay vote
  - Was non-binding
  - Did not overrule decisions of the board of directors
  - Did not change fiduciary duties
  - Did not add fiduciary duties
- Reputational risk
- Costs of litigation and potential settlements, even if successfully defended

Proxy Access—SEC Rulemaking

- On August 25, 2010, the SEC adopted Rule 14a-11, its proxy access rule, to allow shareholder director nominations through a public company's proxy statement
  - Stockholder or group owns 3% of voting power for 3 years
  - Companies only required to include in proxy statement the greater of one shareholder nominee or 25% of board
- In addition, the SEC amended Rule 14a-8 to require public companies to include in their proxy materials shareholder proposals to amend governing documents relating to nomination procedures or disclosures related to shareholder nominations

Proxy Access—Litigation

- On September 29, 2010, Business Roundtable and the U.S. Chamber of Commerce challenged the SEC's proxy access rule in the D.C. Circuit Court of Appeals
- On October 4, 2010, the SEC stayed application of rule pending the outcome of the litigation
- On July 22, 2011, the U.S. Court of Appeals for the District of Columbia vacated Rule 14a-11

Related Rules

- SEC's related rules became effective:
  - 14a-8 requiring inclusion of shareholder proposals
  - New Form 14N required by any party nominating a director for inclusion in a company's proxy statement
  - 14a-4 changes to proxy card requiring voting separately for each director if a shareholder nominee
  - 14a-2 exemptions from proxy solicitation requirements
  - Form 8-K filing if change in meeting date of more than 30 days from prior year's date

Current Proxy Access Procedure

- Two-step process now exists
  - Year 1 shareholder proposes changes to nomination procedures in governing documents through Rule 14a-8 shareholder proposal process
  - If proxy access shareholder proposal passes, in Year 2 (or subsequent years) shareholder proposes nominee for inclusion in public company proxy materials

Types of Proxy Access Shareholder Proposals in 2012

- Norges Bank
  - Binding by-law amendment
  - Shareholder or group owns 1% for at least 1 year
  - Each shareholder or group could nominate up to 25% of board
  - Proxy access nominees cannot exceed 25% of board
- Norge's promotion efforts
  - Link in supporting statement to website with additional arguments
  - Additional solicitation materials filed with SEC

Types of Proxy Access Shareholder Proposals in 2012 (Cont'd.)

- U.S. Proxy Exchange
  - Precatory bylaw amendment
  - Holders of 1% for two years
  - 100 holders with $2,000 worth of stock for one year
  - Each eligible shareholder could nominate up to one-twelfth of the board
  - No overall limit on proxy access nominated directors
  - Election of a majority is not a change in control

Types of Proxy Access Shareholder Proposals in 2012 (Cont'd.)

- Pension Funds
  - Shareholders or groups owning 3% for 3 years
  - Similar to SEC's vacated 14a-11 rule
- Furlong Fund
  - Shareholders or groups holding 2% for one year
  - Shareholders or groups holding 1% for one year
  - Shareholders or groups holding 15% for one month
    - In proxy contest context
  - Each was a binding proposal
  - Each shareholder or group limited to one nominee but no overall limit

Permitted Exclusions of Proxy Access Shareholder Proposals in 2012

- Contained multiple proposals
  - Separate and distinct proxy access and change in control proposals
  - *Bank of America Corporation* (avail. Mar. 7, 2012)
- Proposal described ownership requirements by cross reference to SEC rules
  - Made proposal impermissibly vague
  - *Chiquita Brands International, Inc*. (avail. Jan. 5, 2012)
- Proposal conflicted with existing bylaw provision
  - *Staples, Inc.* (avail. Apr. 13, 2012 and Apr. 19,2012)

Unsuccessful Attempts to Exclude Proxy Access Proposals

- SEC *denied* no-action relief based on the following arguments:
  - Vague and indefinite because website not yet functional
  - Substantially implemented because bylaw amendment adopted
    - With a higher ownership threshold
  - Violation of state law

Efforts to Exclude Proxy Access Shareholder Proposals

- Exclusions negotiated with proponents based on governance changes
  - Hewlett-Packard agreed to include a management proxy access proposal in its 2013 proxy statement
- Expect proponents to eliminate features in 2013 proposals that permitted exclusion
  - More difficult to exclude proxy access shareholder proposals

Receipt of Proxy Access Proposal

- Check for technical deficiencies immediately
  - Respond within applicable deadlines
- Evaluate whether any other grounds for exclusion exist
- Prepare the statement in opposition for the proxy statement
- If included in proxy statement
  - Review proxy advisory firm recommendations
  - Consider whether additional soliciting materials should be prepared and filed

Should Management Propose an Alternative Proxy Access Scheme?

- Discuss likelihood of approval of shareholder proxy access proposal with investor relations department and/or proxy solicitor
  - In 2012, most proxy access shareholder proposals failed
  - Nabors Industries and Chesapeake Energy were notable exceptions
- Shareholders could propose an amended or different proxy access proposal for inclusion in a future proxy statement
- It might be possible to exclude the shareholder proposal on a basis other than conflicting with another proxy proposal
- It is possible that shareholder could argue that the proposals are too different to conflict
- Some companies may perceive a corporate governance benefit for adopting a management proxy access proposal

Staff Legal Bulletins

- In addition to Rule 14a-8 and related no-action letters, review legal bulletins on shareholder proposals issued by the Staff of the Division of Corporation Finance
- Latest is Staff Legal Bulletin No. 14G, issued October 16, 2012, addressing
  - Parties that can provide proof of ownership
  - Manner in which companies should notify proponents of failure to provide proof of ownership
  - Use of website references in proposals and supporting statements

General Shareholder Proposal Process

- Following receipt of a proposal, determine whether eligibility and procedural requirements are met and notify proponent of any deficiencies (14 days)
- If intend to exclude proposal, must notify SEC and proponent (no later than 80 calendar days before definitive proxy materials are filed)
  - No-action letter request procedure
- If the proposal is not excluded, company must provide the proponent with a copy of it statement in opposition 30 days prior to filing date

Likely Shareholder Proposal Topics – Corporate Governance Issues

- Board declassification/annual director elections
- Majority voting
  - Those that failed were mostly at companies with plurality voting with a resignation policy
- Action by written consent
  - Concerns about disenfranchisement of some shareholders
- Special meetings
  - Seek to enhance shareholder ability to call special meetings

Likely Shareholder Proposal Topics - Corporate Governance Issues (Cont'd.)

- Cumulative voting
  - Institutional shareholders generally not in favor
- Independent chairman
  - If strong alternative structure, shareholders not likely to approve
- Supermajority voting
  - Seeks to remove supermajority voting provisions

Likely Shareholder Proposal Topics – Environmental Issues

- Climate change
  - Typically a report on efforts to reduce greenhouse gas emissions
  - Also, financial risks arising from climate change, adoption of principles to stop global warming
- Sustainability
  - File reports on sustainability efforts
- Other environmental issues
  - Hydraulic fracturing, coal-related proposals, recycling, water scarcity, oil sands, toxic substances

Likely Shareholder Proposal Topics – Other Issues (Cont'd.)

- Political contribution related proposals
  - Following the U.S. Supreme Court's *Citizens United* decision lifting many restrictions on corporate and union political spending
- Human Rights
  - General human rights policies, genocide-free investing
  - Sexual orientation/gender identity nondiscrimination

- Additional topics to keep in mind
  - Compensation Committees
  - Compensation Consultant Disclosures
  - Open Dodd-Frank Disclosure and Related Provisions
  - D&O Questionnaires
  - Proxy Plumbing

Compensation Committees

- In June of 2012, the SEC adopted new Rule 10C-1 under the Exchange Act
- Implemented Section 952 of the Dodd-Frank Act
- Among other things, 10C-1 requires the stock exchanges to revise their listing standards with respect to:
  - Independence of compensation committee members
  - Requirement to consider independence of compensation consultants, legal counsel or other advisors prior to selection

Compensation Committees (Cont'd.)

- Rule 10C-1 requires stock exchanges to revise their listing standards to require boards to consider relevant factors when determining whether a compensation committee member is independent, including:
  - The source of the board member's compensation
  - Whether a board member is affiliated with the issuer, a subsidiary of the issuer or an affiliate

Compensation Committees (Cont’d.)

- Rule 10C-1 also provides that a compensation committee may only select an advisory only after taking into account the following factors:
  - The provision of other services to the issuer by the person that employs the adviser
  - The amount of fees received from the issuer by the person that employs the adviser
  - The policies and procedures of the person that employs the adviser that are designed to prevent conflicts of interest
  - Any business or person relationship of the adviser with a member of the compensation committee, or of the adviser or the person employing the adviser with an executive officer of the issuer
  - Any stock of the issuer owned by the adviser

Compensation Committees (Cont'd.)

- NYSE and NASDAQ submitted to the SEC proposed revisions to their listing standards in September of this year
  - Both propose to require that in affirmatively determining independence to serve on the compensation committee, the board must consider all of the factors relevant to determining whether a director has a relationship that is material to that director's ability to be independent from management in connection with being a compensation committee member
  - Both propose that a board consider the identified factors prior to retaining an advisor
  - Neither has proposed any additional standards or established any bright-line tests, other than those that already exist for director independence

Compensation Committees (Cont'd.)

- NASDAQ proposed a few additional revisions
  - NASDAQ-listed companies now must have a compensation committee consisting of at least 2 independent members
  - The compensation committee must have a charter addressing certain required items and that specifies that the CEO may not be present during voting and deliberations by the compensation committee on his or her compensation
  - Many NASDAQ companies already have compensation committees that have a charter. They will need to be reviewed for compliance with new requirements

Compensation Committees (Cont'd.)

- NYSE companies will have until the earlier of their first annual meeting after January 14, 2014 or October 31, 2014 to comply with the new independence requirements and until July 31, 2013 to comply with the other changes
- NASDAQ companies will have to comply with the changes relating to compensation committee responsibilities and authority and the obligations to consider adviser independence factors immediately upon effectiveness of the proposed changes and until the earlier of their second annual meeting after effectiveness of the new standards or December 31, 2014 to comply with the other proposed changes

Compensation Consultant Disclosure Issues

- Item 407(e)(3)(iii) requires disclosure of the role of compensation consultants in determining or recommending the amount or form of executive and director compensation during the last completed fiscal year, identifying:
  - The consultants
  - Who engaged the consultant
  - If the consultant provided additional services to the issuer in excess of $120,000, then separate disclosure of the aggregate fees for determining executive and director compensation and the additional services

Compensation Consultant Disclosure Issues (Cont'd.)

- If an identified consultant has an actual conflict of interest, new Item 407(e)(3)(iv) requires disclosure be provided concerning the nature of the conflict and how it is being addressed
- Provision is applicable to proxy statements filed with the SEC in relation to annual meetings at which directors will be elected that occur on or after January 1, 2013

Open Dodd-Frank Disclosure and Related Provisions

- Pay-for-Performance
- Internal Pay Comparisons
- Hedging
- Clawbacks
- Vote Reporting by Institutional Investment Managers

D&O Questionnaires

- Likely no changes

Proxy Plumbing

- Fees for Proxy Distribution
  - Activity at the NYSE which could result in a change to the fees paid in connection with the distribution of proxy material
- Proxy Advisors
  - Exxon Mobil comment letter to concept release submitted to SEC on August of 2012 discussing the importance of full disclosure by proxy advisors

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