Previewing Proxy Season 2015

by Patrick Quick and John Wilson

If there was ever an era of uneventful annual meetings in the U.S., that time has long passed. For 2015, your board may face a fresh wave of proxy challenges from more sophisticated, effective investor activists on issues like executive pay, cybersecurity, corporate strategy, and the makeup of your board itself.

In 2014, corporate directors faced a host of new challenges, plus many old ones—a trend that we expect to continue in the 2015 proxy season. The issues raised include shareholder activism, proxy access, board refreshment and diversity, cybersecurity, and executive compensation. These share a common core: the rising influence of shareholders.

☐ ***Continued rise of shareholder activism.*** Shareholder activism has come a long way since the 1980s heyday of renegade corporate raiders. Activists have enjoyed significant successes lately, in terms of both influence and firepower. Activist funds now routinely obtain board seats at public companies and raise substantial capital from investors.

No company is safe anymore, as activists have gone from focusing on smaller companies in which they could take a sizable position, to routinely targeting large cap, brand-name companies. Even good financial and stock price performances are no longer ways to ward off activist attention. If a company and its stock price are performing well, activists may find an audience if they can show a path to "more." Shareholder activism dominated the headlines during the proxy season in 2014, and you can be nearly certain that this trend will continue in 2015.

Why? Shareholder activism is a classic case of success begetting success. As activist funds moved from the fringes to the mainstream, the corporate ecosystem has evolved. Institutional shareholders and proxy advisory firms are now more willing to listen to and align themselves with the activist campaigns that they once viewed as upstarts. The number of campaigns waged against S&P 500 companies in 2014 more than tripled compared to 2006, according to FactSet.

The increased prospects for success (and consequent financial windfalls) have emboldened activists, who are now more willing to expend significant resources and time developing their battle plans. In some cases, activist funds pour millions of dollars into research, spending months gathering evidence for their cases. Shareholder activism has thus created its own momentum. According to FactSet, activist shareholders were successful (through either a settlement or a shareholder vote) in 72 percent of proxy fights in 2014, up from 60 percent in 2013.

Compounding the power of activist funds is the fact that the defensive tactics companies long used to repel them are being eroded by both internal and external forces.

Investors continue to flock to activist funds, due in no small part to their rates of return, which outstrip other hedge funds. The war chests at activist funds grew by 9.3 percent to $111 billion in the first half of 2014, according to hedge fund industry research firm HFR. These numbers indicate that the market for shareholder activism remains ascendant, and that investors expect these funds to remain highly active.

Compounding the swelling power of activist funds is the fact that the defensive tactics companies have long used to repel them are being eroded by both internal and external forces. Many companies, under pressure from shareholders and activist investors, have unraveled the protections they assembled in the 1980s to ward off hostile raiders.

Classified boards, which prevent an activist from acquiring control of a company at a single shareholders' meeting, have been eliminated at most

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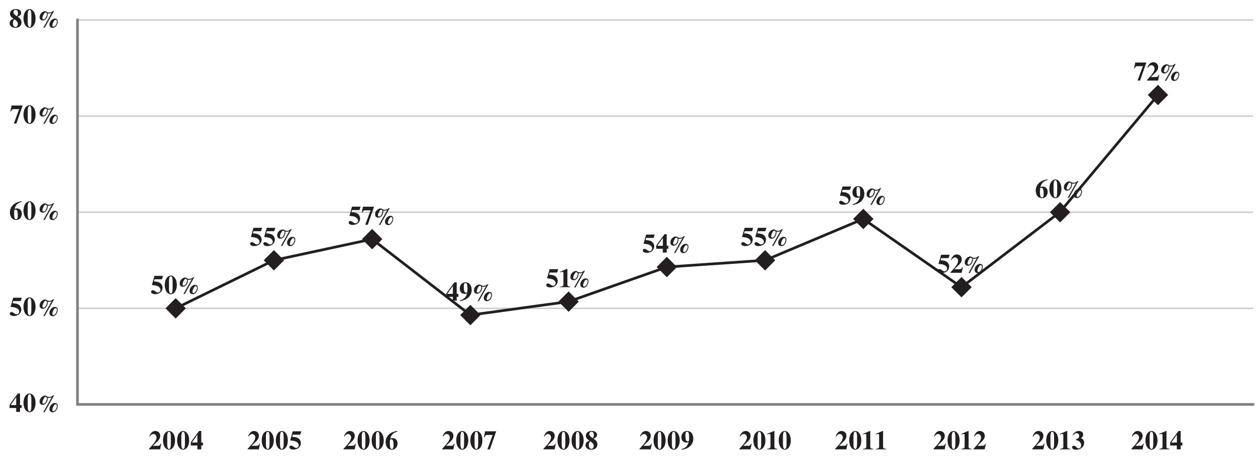
Proxy Success Breeds Success

Dissident Success Rates In Proxy Contests



Number of outright victories, partial victories or settlements by the dissident as a percentage of all proxy contests where an outcome has been reached, as of December 10, 2014.

Source: FactSet

large-cap companies. Only 9.8 percent of S&P 500 companies continue to maintain classified boards, according to FactSet.

Even the vaunted rights plan, or "poison pill," which deters any single investor from accumulating a significant percentage of a company's stock, often does not offer adequate protection. First, as a result of shareholder and proxy advisory firm objections, many companies do not now have a plan in place, and they are reluctant to adopt one. Second, for the limited few with a plan, it does not effectively deter hedge fund "wolf pack" attacks, where a number of nominally independent funds jointly acquire a significant block of a company's stock.

It has been increasingly common for activists to expect that one or more outside directors will meet with them, and for directors to oblige.

Boards that ignore the strategies that activist shareholders propose may face consequences. A prime example of the shift in power from inside to outside the boardroom was the shareholder action to eject the entire board of dining giant Darden Restaurants in October 2014. Activist investor Starboard Value led the ouster of all 12 directors at a special meeting called by shareholders after the company agreed to sell its Red Lobster business when Starboard and other shareholders had urged a spinoff of additional businesses.

However, there are steps boards can take to reduce the chance of drawing attention from shareholder activists or to prepare for an activist attack. We expect that directors will be more proactive to head off shareholder advances. Companies that meet with shareholders (both activists and traditional institutional investors) early and often, instead of waiting to resolve differences during proxy season, increase their odds of success.

It has been increasingly common for activists to expect that one or more outside directors will meet with them, and for directors to oblige. In appropriate circumstances, at least one director may also go on the road with management to meet with shareholders. In today's environment, activists may have the opportunity for dialogue with large investors several times a year. In contrast, if company management and directors reach out only when the fire alarm rings, they are starting from behind.

Companies can anticipate, prepare for and react to a proxy access proposal, so they should consider their strategies in advance.

☐ ***Proxy access, board refreshment and board diversity.*** In 2011, a D.C. appeals court overturned a short-lived requirement from the Securities and Exchange Commission (SEC) that shareholder nominees for boards be included in company proxy materials. Some felt that this closed the door on proxy access. However, the case left the door open for shareholder proposals on the subject involving so-called "private ordering" (implementing proxy access on a company-by-company basis).

In the following years, shareholder proposals trickled in, with mixed results at the polls. In response to these proposals, some public companies have adopted the measure voluntarily.

To date, though, there has not been a groundswell of proposals. That could change in 2015 as new players continue trying to build momentum behind proxy access. Among the most significant efforts is the Boardroom Accountability Project (BAP), run under the auspices of the New York City Comptroller. Backed by the heft of New York City's $160 billion pension funds, the BAP next year will serve 75 companies. These companies will be targeted with proxy access proposals because of perceived sustainability, diversity and/or executive compensation deficiencies.

The campaign is intended to provide investors with a larger voice in director nominations, and is modeled largely after the SEC rules that were overturned in 2011. The proposal seeks adoption of a bylaw that would allow a shareholder who has owned at least three percent of the company's shares for at least three years to nominate candidates for election to the board.

There are ways that a company can anticipate, prepare for and react to a proxy access proposal, so this is a subject they should be considering in advance. For instance, it is helpful for a company to do an internal review to identify any governance concerns that shareholders might raise, making the company the target of a proxy access proposal.

It is also beneficial for a company to try to understand where its larger shareholders stand on proxy access, and how they have voted on the issue in the past to gain a better sense of how such a proposal would fare. Finally, it is helpful to regularly communicate with larger shareholders.

Interestingly, proxy access in some ways runs counter to two other shareholder trends. First, activist shareholders typically cannot use proxy access. Also, where proxy access results in more nominees than seats up for election, which is the normal result, majority voting does not apply. Majority voting has become fairly common over the last 10 years based on shareholder efforts.

Two related issues—board turnover and diversity—will continue to be shareholder priorities in 2015. Emphasis on new skills, such as technological expertise, and a fresh perspective in the boardroom will place further pressure on companies to remake the composition of their boards. Activist shareholders also often focus on long-tenured directors when they wage proxy contests.

In addition, a number of companies faced shareholder proposals in 2014 seeking a report on board diversity, particularly in relation to the number of women and racial minorities on boards. We anticipate the same in 2015. We expect companies to respond to these trends by placing new members on their boards, demonstrating that they take questions of an appropriate perspective, relevant competencies and diversity seriously.

Given the wave of cyberattacks, investors may now view such breaches as inevitable—but they remain unforgiving about fumbling or insensitive company responses.

☐ ***Cyber-security risk.*** Last summer, SEC Commissioner Luis Aguilar took to the floor of the New

York Stock Exchange and told the audience that "ensuring the adequacy of a company's cybersecurity measures needs to be a critical part of a board of director's risk oversight responsibilities."

The new focus on cybersecurity dovetails with a larger trend that's developed in the wake of the 2008 meltdown—the intersection of corporate governance and risk management. With the lessons of the Great Recession still fresh, shareholders began to expect directors to protect their companies with operational steps to head off disaster before it strikes.

In 2009, the SEC codified this expectation by requiring that public companies disclose the board's role in risk oversight, calling it a "key competence of the board." If directors are to be effective governors and shepherds, they need to protect shareholders' assets.

Thanks to a series of high-profile breaches, cybersecurity is now the most visible area of risk management. When it comes to such significant events, the buck understandably stops with the board of directors, even if many were appointed in an era before such concerns manifested themselves.

Needless to say, one need not be an expert in source-code firewalls or digital forensics to be an effective corporate director. However, given the level of cybersecurity oversight with which boards are charged, many will now search for directors with expertise to oversee and evaluate the operational elements of a company's data security program.

These skills extend beyond the core competencies of many traditional directors. Other aspects of cybersecurity governance, such as risk assessments and mock stress tests, as well as recommending necessary infrastructure enhancements, will also require a deeper technical knowledge. The board may look to a new outside director and to outside third parties advising the board.

Certain essential elements of oversight do not require high-level knowledge of computer science. They include ensuring that a company understands its data, knows who controls it and seeks appropriate insurance coverage to mitigate the impact of potential breaches.

Perhaps most importantly, boards will continue to develop processes for risk oversight and delegation. To this end, we expect boards will demand that relevant company personnel brief them on a regular basis. These briefings should contain essential information on the number of attempted attacks and the aggregate cost of the incidents.

Risk management also entails mitigating damage when the unforeseeable does occur. This exercise requires public relations teams that are both nimble and prepared. Because significant cybersecurity breaches invite such a high level of public scrutiny and media coverage, the response can result in more lasting damage to a company's reputation than the breach itself.

According to a study released by the Ponemon Institute last September, 43 percent of responding companies had endured a data breach in the last year. Given the plethora of attacks, investors may now view such breaches as inevitable—but they remain unforgiving about fumbling or insensitive responses.

After a tumultuous year in cybersecurity, boards that do not equip their companies with the necessary institutional expertise to combat and mitigate cyberattacks may find themselves under fire in 2015.

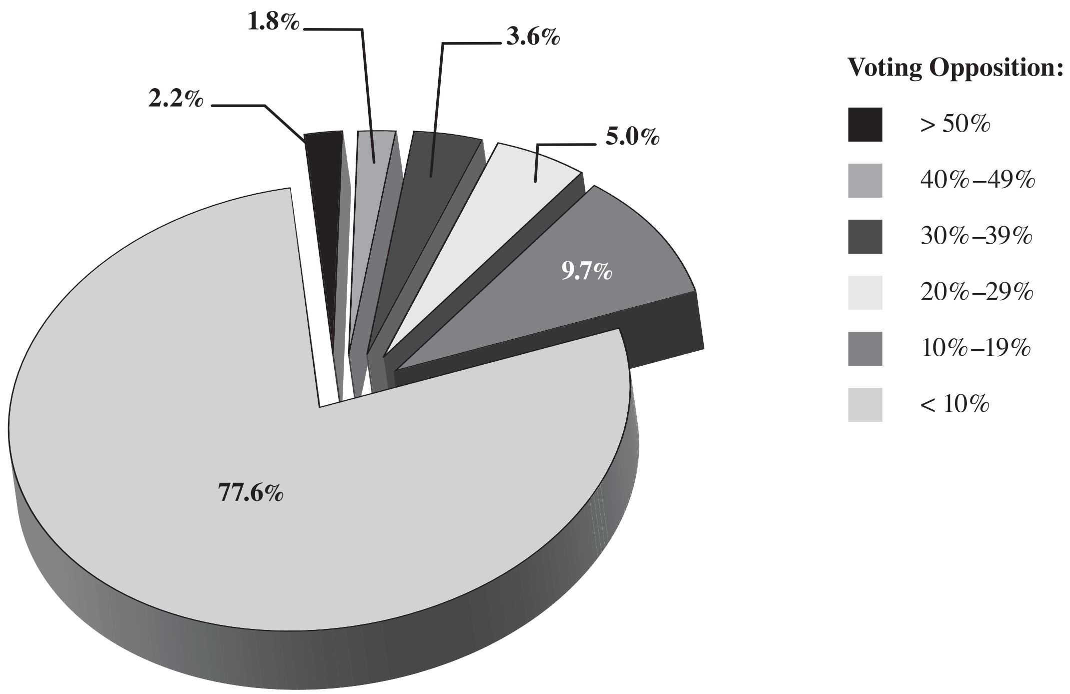
Boards are reaching out to shareholders earlier and more often to discuss executive compensation.

☐ ***Say-on-pay and equity awards.*** Executive compensation is also another hot proxy topic this year. In 2011, SEC rules adopted pursuant to the Dodd-Frank Act required nonbinding say-on-pay votes regarding executive pay. Shareholders have generally proven amenable to the packages that boards have since put forward. We believe 2015 will follow suit. ISS reports that, in 2014, pay packages on average received 92 percent approval, only 2.2 percent failed to hit 50 percent, and 8 in 10 proposals received at least 90 percent approval.

Of course, ISS is not the last word on executive pay. ISS recommended voting against say-on-pay proposals at 11 percent of companies in 2014; the actual number of failed votes was far less. In addition, shareholder engagement appeared to work for

Investors Have Been Pay Positive

Say-On-Pay Support Remains High



Based on 2014 vote results for 2,417 Russell 3000 firms. Data does not include abstentions.

Source: Institutional Shareholder Services Inc.

companies with failed votes in 2013. A majority of these companies received greater than 70 percent support in 2014, according to Alliance Advisors.

As with activist investor relations, boards appear to be reaching out earlier and more often to discuss questions of executive compensation. The most common reasons for failed say-on-pay votes during the last few proxy seasons were:

□ A perceived disconnect between the CEO's pay relative to performance of the company.

□ Poor stock performance.

□ Insufficiently rigorous performance goals.

□ Pay programs that included a disproportionate amount of special awards, mega-grants or non-performance based equity.

□ "Problematic" pay practices, such an excessive perks and severance packages that total more than three times a CEO's base salary and bonus.

Companies that have any of these elements present in their pay practices should consider actively addressing them through disclosure or shareholder engagement or taking steps to change their compensation practices.

There are, however, important ways in which 2015 diverges from previous years, particularly on shareholder approval of equity plans under which companies grant awards to executives. We expect a more nuanced discussion and a brighter spotlight to shine on proposals seeking approval of equity pay. Under a series of new metrics that ISS will roll out, equity plans will be graded on a scorecard. This is a change from the binary endorsement system, consisting of a series of "pass/fail" tests that ISS previously employed.

These scorecards will focus on three broad categories. The first compares the total estimated cost of the company's equity plans to industry/market-cap peers. The second category will rate the plan's design features, such as single-trigger vesting, discretionary vesting authority and minimum vesting periods. The final category assesses the company's grant practices.

While the new approach will provide additional guidance for shareholders, ISS plans to preserve some of the bright-line tests for elements it calls "highly egregious," regardless of the totality of the plan. These elements include the authority to reprice options without seeking shareholder approval and liberal change-of-control definitions that triggers accelerated vesting.

If all goes according to plan, in late 2015 the SEC will release its final rules for another Dodd-Frank requirement, the CEO pay-ratio disclosure. This will require that companies tell shareholders how much their CEO makes in relation to an average employee. While this number will likely provide ammunition for headlines about runaway executive pay, we do not believe that the different framing mechanism will cause shareholders to pursue no votes on say-on-pay proposals more aggressively.

Shareholders themselves often bring pay-related proposals, such as votes to eliminate golden parachutes or curtail other change-of-control benefits and address accelerated vesting of equity awards. Of late, institutional investors (not retail investors) have more frequently voted for these proposals. This shift provides an opportunity for companies to reach out earlier and begin negotiations rather than try to block the proposal or win the vote outright.

Historically, a company could focus on obtaining votes at its annual meeting over about four months of the year, from January through the spring for most companies. This is now a year-round concern. The rising influence of shareholders underscores the importance of companies engaging regularly with shareholders and paying attention to issues on an ongoing basis. ■

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