The LEXIS PRACTICE ADVISOR Journal™
SUMMER 2017
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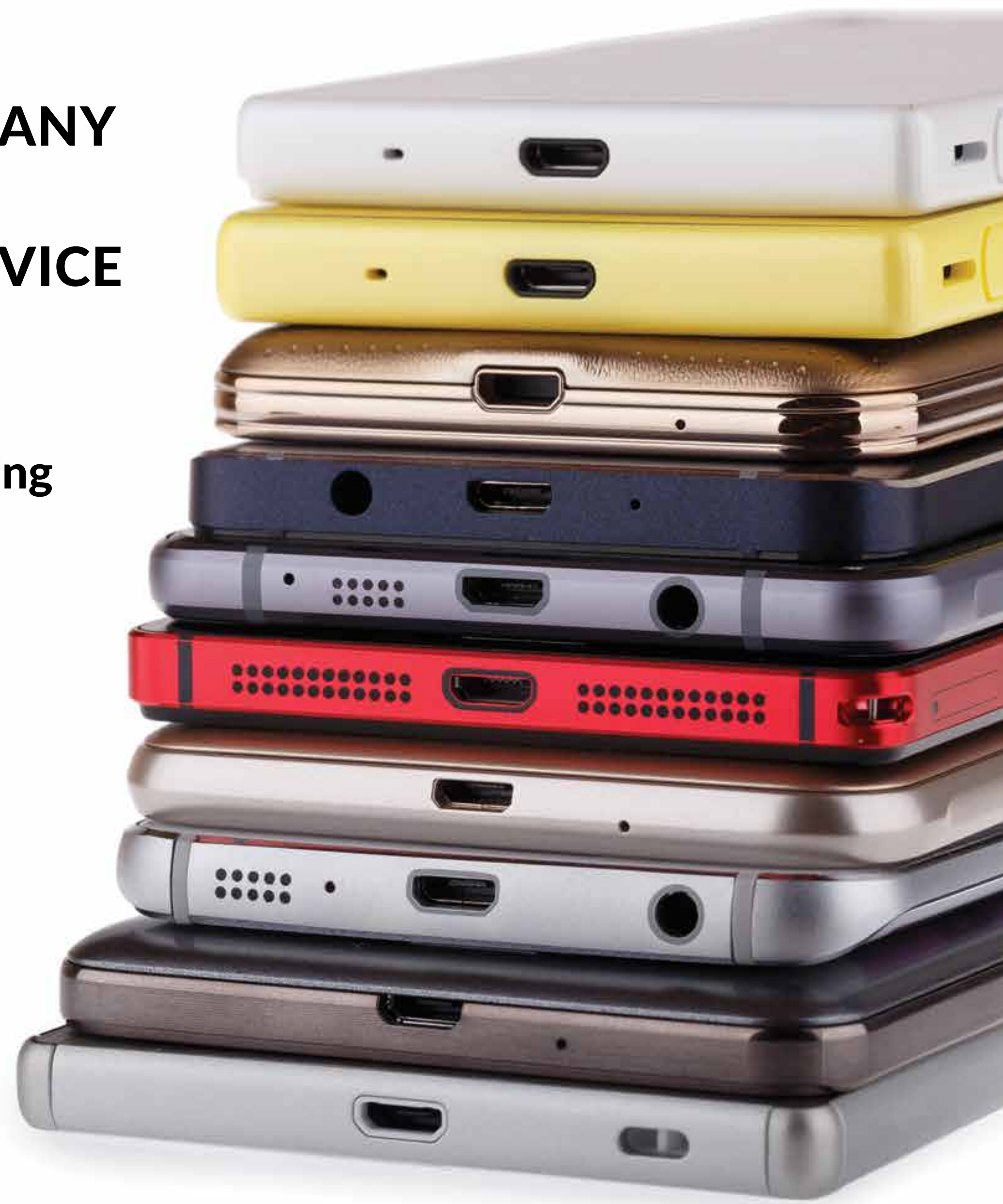

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# Proxy Season 2017

## Q&A with Keir Gumbs

PARTNER AT COVINGTON & BURLING LLP

**Keir Gumbs, vice chair of the Securities & Capital Markets Group and partner in the Washington, D.C. office of Covington & Burling LLP, regularly provides insights about the trends he observes in securities law and shareholder activism. Prior to joining Covington & Burling, Keir served in the Office of Chief Counsel in the SEC's Division of Corporation Finance and as Counsel to SEC Commissioner Roel C. Campos. He provides a unique perspective on corporate governance as a result of his public service and private practice experience. We recently sat down again with Keir and asked him to update our readers on the major issues that he is seeing during the 2017 proxy season.**

Keir Gumbs

COVINGTON

COVINGTON & BURLING LLP

**Institutional Shareholder Services (ISS) and Glass Lewis have announced modifications and updates to some of their proxy voting guidelines for the 2017 proxy season. These include guidelines relating to issues such as equity compensation plans, cash and equity incentive plans, say-on-pay proposals, director compensation, director overboarding, and undue restrictions on shareholders' ability to amend the bylaws. Where do you think ISS and Glass Lewis will have the most significant impact on corporate governance during the 2017 proxy season?**

I think that proxy advisory firms as a general matter have historically had the most influence, and will continue to have that influence, with respect to executive compensation, and specifically with respect to their evaluation metrics and methodology for executive compensation that's been paid and for employee benefit plans, such as stock plans, incentive plans, and things of that nature. That is interesting because their recommendations with respect to director elections get a lot of attention, and their say-on-pay recommendations get a lot of attention, but I think that when you get down to it, where they have the most influence over decision-making by companies is in executive compensation plan design.

As an example, if a client is working on an equity compensation plan, and we're thinking about tax requirements, governance practices, best practices, and things of that nature, all of those things are very important because basically you want to comply with the law. But the place where otherwise a company would be unconstrained is with some of the elements of the plan design, such as limits on the types of awards that can be given, the level of specificity with respect to performance measures, limits on individual compensation that can be awarded under the plan, things of that nature, and most importantly, how much they can seek approval of for the plan to the extent that it is an equity incentive plan. And with respect to that question, particularly, I found in practice that ISS and Glass Lewis have an outsized influence.

I have seen clients dramatically change the incentive plans that they were going to seek shareholder approval of in response to expected concerns by ISS or Glass Lewis. I don't think that is going to change in 2017. I don't know that it's going to be much more pronounced in 2017 than it was in prior years, but I do continue to think that's the most significant influence that they have.

The next most important and influential area is probably around shareholder proposals, and this one I think can be a bit of a surprise because when people think about shareholder proposals, they think of them as the precatory requests that get sent in by shareholders that companies are not obligated to pursue. I think that's generally right, except that if you have a shareholder proposal that is approved by a majority of the shareholders, then there is the expectation that you will take action on it, or there is a risk that ISS or Glass Lewis will recommend or withhold votes against your directors the following year. That has really changed the dynamic around shareholder proposals. So companies spend a lot more time and money thinking about proposals when they get them, thinking about whether to implement them and, if so, how. To the extent that a company is not going to implement a shareholder proposal, the company is thinking very hard about what it needs to do in order to ensure that the proposal does not pass, because if it does pass, they have to do something. Those are the two areas that ISS and Glass Lewis have had the most significant influence historically, and I don't think that is going to change this year.

**The SEC staff granted a number of no-action requests that were sought by companies in 2016. In light of the presidential election results, do you expect an increase in no-action requests by companies, and what do you expect the SEC response to be to no-action requests during 2017?**

Regarding the influence that the Trump administration and the impending change at the SEC will have over shareholder proposals, for the most part, changes in administrations don't really influence in a very meaningful way the manner in which the SEC evaluates and decides no-action requests related to shareholder proposals. When I was at the SEC under the Bush administration, the White House and the White House's views on issues almost never, if ever, influenced decisions. I can't think of any instances where it influenced our decision-making process. We certainly were aware of the environment in which the decisions that we were making would be received and how that might influence the debate that was taking place, but at the end of the day we always looked at what does the rule say, what does the case law say, what does our precedent say, and based our decision on those factors. So I don't think that's going to change under this administration.

However, I do think there are other ways in which the change in administration can indirectly impact shareholder proposals and corporate governance and actually proxy access is a tremendous example of that. I'll give you two very specific ways in which the SEC and the leadership of the SEC influenced the proxy access debate. If you remember, 20 years ago proxy access did not exist. It was something that shareholders were asking for, but not something that the SEC had at that point been able to successfully address through rule-making or otherwise.

Under Mary Shapiro's tenure, the staff was evaluating two rule-making proposals relating to proxy access. One that would make proxy access universally required, and another where it would allow shareholders to submit proxy access shareholder proposals, which before they could not do. As I understand it, the SEC was debating these questions: Should we adopt both rules, should we just follow one approach, and if so, which approach is the best one? Should we just use the universal mandatory rule, or should we allow both of them? Ultimately after some significant debate, Chairwoman Schapiro decided to move forward with both proposals.

And at that time, most people, including me, looked at that decision and thought, "This is very odd." Because on one hand you have the universal proxy rule that all companies will be subject to, and at the same time they were adopting shareholder proposal amendments that allowed shareholders to basically enhance or expand those proxy access rights through the shareholder proposal process. It seemed odd, almost like a "belt and suspender" approach to proxy access.

In hindsight it turned out to be a genius move for someone who was an advocate for proxy access. That's because the rule that would have imposed proxy access on all public companies went away the following year. So then the SEC was stuck with the shareholder proposal amendments, which eventually allowed the creation and proliferation of proxy access regimes through the shareholder proposal process. When we look today at the number of companies that have adopted proxy access, which is somewhere over 400 in the beginning of March, we see the direct result of that decision by SEC Chairwoman Mary Shapiro. So that's one example of how decision-making by leadership at the SEC can directly influence no-action letters and ultimately corporate governance.

Similarly, two years ago SEC Chair Mary Jo White made a decision that significantly impacted the trajectory of proxy access. Under the shareholder proposal rule, there is an exclusion that lets a company exclude a proposal on the basis that it conflicts with a management proposal. The way it worked, as long as the two proposals addressed the same topic, even if the management proposal and the shareholder proposal were doing the opposite things, a company could exclude the proposal on the basis that they conflicted with each other. In the context of proxy access shareholder proposals, a lot of companies were thinking about adopting or putting forth their own management proposals relating to proxy access that would have taken a very different approach. For example, the shareholder proposal could have requested a proxy access bylaw with a 3% minimum ownership, and the company's proposal could impose a 5% or 7% minimum ownership requirement. Many companies wrote into the SEC to exclude those shareholder proposals on the basis that they conflicted with management proposals seeking to impose more restrictive thresholds.

Initially, the SEC staff agreed with companies that they could exclude proxy access proposals under the conflicting proposal exclusion because that position was consistent with what the staff had done historically from a no-action letter perspective. Then came letters and other expressions of concern from a number of institutional investors, including the Council of Institutional Investors and CalPERS, all pointing out that this was an outcome that would permit companies to undermine proxy access through the adoption of management proxy access bylaws that were significantly more onerous and basically made it impossible for shareholders to use.

SEC Chair Mary Jo White heard some of the those concerns and directed the staff to stop issuing no-action letters based upon the conflicting proposal exclusion, at least until the staff could review the exclusion and decide if it made sense to apply it as had been applied historically. Following that review, the staff dramatically narrowed the way that they interpreted the conflicting proposal exclusion under Rule 14a-8, which meant that companies that wanted to exclude proxy access shareholder proposals either had to find a deficiency in the proposal, which is pretty hard to do since they are pretty well drafted, or they had to adopt their own proxy access bylaws and argue that they were substantially implemented. That result dramatically increased the uptick of proxy access bylaws between 2014 and 2017.

I think that decision by Mary Jo White is probably the single most significant decision impacting proxy access in the last 20 years, other than the previous decision by Mary Shapiro. But I think these illustrate the significant ways in which the next chair of the SEC could conceivably impact shareholder proposals going forward.

### Dodd-Frank required companies to obtain shareholder approval of say-on-frequency, setting the time periods for shareholder votes on say-on-pay to one, two, or three years. The first round of say-on-frequency approvals occurred in 2011, and those companies are required to conduct the next round in 2017. How are companies handling this requirement in 2017, and what time period do you think most companies are asking for this year?

The first time around, I think companies went out with proposals that they actually wanted. Companies wanted three years because they thought it aligned well with their compensation plans, gave them more time to plan and prepare, and they weren't in this constant cycle of responding to or preparing for say-on-pay votes. Nevertheless, shareholders overwhelming favored an annual say-on-pay vote, so that's what most companies ultimately ended up with. The last number I saw was that 90% of companies had adopted an annual say-on-pay vote. So looking forward to this year, I think most companies, with maybe a few exceptions such as controlled companies, have decided that they are just going to ask for annual votes.

Why create an issue with shareholders when they don't have to? Most shareholders are used to doing one-year; most companies are used to doing say-on-pay every year. In terms of votes, most votes have been in favor of say-on-pay. Somewhere around 89% of companies received more than 90% approval on their say-on-pay vote. Because of that, I think companies would be loath to go back to where we were in 2011 and upset the apple cart by asking for triennial votes rather than annual. There will certainly be some companies that request triennial votes, but I think most companies have decided that annual say-on-pay votes are something that they are used to, so why create a lot of drama around something that is unnecessary?

### What is the status of Dodd-Frank in 2017 as it relates to corporate governance, and do you have a predication on what Congress and President Trump will do in 2017 with Dodd-Frank, both as to the existing regulations that have already been promulgated and the remaining areas where regulations have not yet been promulgated?

That is a million-dollar question. There are some things we can say with 100% certainty. I am 100% confident that the

drafts or proposals or even the adopted Dodd-Frank rules relating to corporate governance and executive compensation are not going to stay the same. For example, the pay-ratio rule is set to go into effect for next year, and the acting chair has already taken steps against the rule. It is highly likely that the SEC will either give some sort of exemptive relief to categories of companies from that rule or there will be temporary relief for everyone. They may suspend the rule for a year so they can do more study and evaluation, or there is the possibility that they will go back to the well and try to amend the rule in a way that makes it more business-friendly or at least less onerous.

And that's just at the SEC. Of course, there is the possibility that there may be a legislative attack on the pay-ratio rule that could eliminate the rule entirely or modify it substantially. My own view, and I think that of most observers, is that something is going to change and that the way that it is going to change is that these rules will either be amended substantially so that they are less burdensome for companies or that they will be temporarily halted. And of course there is the possibility that they will be repealed. I think that is the case for every single one of the Dodd-Frank rules.

Let me just say as an editorial, I thing getting rid of all of them is an overreaction. We just talked about the say-on-pay vote. The say-on-pay vote, while it had no direct correlation to the financial crisis, is easily one of the most significant corporate governance developments in the last decade because it has radically changed the way companies and investors engage. Before say-on-pay, some companies, maybe best-in-practice leading companies, engaged with their investors regularly. I'm not talking about dealing with analysts, I'm talking about going out and meeting with your investors and asking them what their governance concerns are, talking about company performance and executive compensation, all of those things. That happened, but a lot more sparingly than it happened after say-on-pay.

Today I think it is fair to say that most public companies that are subject to the say-on-pay vote engage in some form of investor engagement, whereas that was simply just not the case 10 to 20 years ago. I think that the rule has had a very meaningful positive impact on the way that companies engage with investors. So say-on-pay, while people could still engage without the rule, has given companies and investors good reason to get together and talk about how their relationship is going. A legislative focus on repealing on say-on-pay would miss the boat.

There is actually a great benefit that companies get from the say-on-pay vote, which I don't think Congress is necessarily aware of. Right now the proxy advisory firms use the say-on-pay vote to express their satisfaction or dissatisfaction with a company's executive compensation practices. They like what you are doing, they vote for say-on-pay; they don't like what you are doing, they don't vote for say-on-pay. But most importantly, they are not voting against your compensation committee members or the chair of your compensation committee. If you take say-on-pay away, you no longer have the say-on-pay vote as the buffer. I think it is much better for everyone to have this advisory vote where investors can register their dissent.

**There appears to have been a move toward more transparency by corporations in dealings with shareholders, especially with large institutional shareholders. Do you think this is something that will continue?**

It depends. People like transparency when they have good things to show. I think conceptually the idea of more transparency is definitely taking hold. But what that transparency looks like is the question.

I'll give you a great example—political spending. I think the ship on political spending has sailed. Most companies provide some level of detail around political spending and lobbying. However, that transparency only goes so far right now. For example, even among leading political disclosures, you will find very little information about trade associations and 501(c)(4)s and other types of tax-exempt organizations to which or through which companies engage in political activities. There is more transparency around these types of expenditures than was the case historically, but there is still a pretty significant disagreement between companies and shareholders about what is relevant for transparency disclosures, such as payments to and participation in trade associations and 501(c)(4) organizations.

### Large public pension plans, public advocacy groups, proxy advisory organizations, and public officials such as Mary Jo White, have called for increased board diversity, especially gender diversity. Will the push for board diversity be a significant issue during the 2017 proxy season, and what do you see as the future of proposals for increased board diversity?

I think that among the investor crowd it will continue to be an issue. Even globally, board diversity is an issue that is not going away. But I think there is an important question about whether there are going to be any regulatory requirements that companies take action with respect to diversity. Whether with respect to disclosure about their diversity or the lack thereof in many cases, or just disclosure about their policies with respect to diversity, I think that is an open question.

Under a Clinton administration, I would have taken it for granted that there would have been rulemaking on the subject. Mary Jo White had directed the staff to explore potential rules relating to board diversity, and most institutional investors, certainly the large public pension plans, had expressed very strong support for the idea of enhancing diversity disclosures. But with the new administration, I think there will be more of a do-no-harm regulatory mindset. I think they are going to be a lot more focused on what do we need to do, what is an actual market requirement, as opposed to something that investors might like to have. So voluntary rulemakings, like board diversity, are likely to go away at least from a regulatory perspective even if shareholder advocacy on the topic continues.

### Many institutional investors are considering a company's position on environmental and social issues when making investment decisions and are also submitting shareholder proposals that relate to environmental issues and climate change. What does the environmental battlefield look like for the 2017 proxy season? And are companies going to feel pressure in the future to disclose the financial impact that climate change may have on their operations?

With respect to climate change and environmental-related rule-makings or interpretive guidance, I think it's just not going to happen under this administration. Jay Clayton may come in as SEC Chair—from the perspective of a securities practitioner, he's got the experience. He knows what it's like to prepare these filings, he's been advising companies on compliance, disclosure, and governance; I think he gets it. From the perspective of someone who deals with the agency, and who loves securities law and who loves the policy issues related to securities regulation, it's comforting to know that he is someone who actually knows what the SEC does. Just like his predecessors, he is well-versed in securities regulation issues.

But for things like climate change and other environmental and social issues, it's a much more complicated picture: trying to figure out whether those kinds of factors are material in all circumstances, and if material at all, what about those issues are material; how do you describe those issues; and in the context of a rulemaking, which is extremely relevant to this administration, how do you demonstrate from a cost-benefit analysis that the disclosure or enhanced transparency or governance is going to benefit investors? I think that's a really hard thing to do.

I personally think these are important issues, but it is one thing to say that they are important qualitatively, but an entirely different thing to be able to say that investor confidence will go up this much, that the stock market will benefit that much, or that such disclosures would benefit the economy by a specified amount. In the absence of compelling data of that nature, it is highly unlikely that the SEC will do anything beyond what it has already done, which is basically saying that these issues are important and putting out guidance that explains for markets and for companies how they think climate change and environmental issues can be material, or the circumstances in which they can become material. I'd be very surprised if they do anything more than that.

### Do you have any other observations or predictions about the 2017 proxy season? Are there any common themes emerging in the advice that clients are seeking related to this year's proxy season?

First, more of an observation rather than a prediction—proxy access continues to proliferate every day. We have a chart that we prepare that keeps track of proxy access adoptions and what provisions are included. It's hard to keep up. We had 32 new proxy access adoptions last month, and I think that is going to continue. Right now, many of the proxy access shareholder proposals that have been submitted or the bylaws that have been adopted are concentrated among the larger public companies, and I don't think people should assume that will continue to be the case. I think some institutional and retail investors are starting to take the concept of proxy access and try to push it down to smaller public companies. So we may end up in a world where more companies have proxy access.

The role of no-action letters is also incredibly important. Last year, a number of companies were able to exclude proxy access proposals under Rule 14a-8(i)(10) on the basis that they were substantially implemented by proxy access bylaws that those companies had adopted. This year there has been a change in the approach by shareholders. In addition to submitting proxy access shareholder proposals to companies that have not adopted proxy access, they have also started submitting what we call "fix-it" or "proxy access 2.0" shareholder proposals. These basically seek to ask companies to modify proxy access bylaws that they adopted in prior years.

These proposals raise a real question for the SEC staff. If a company has adopted proxy access already, such that they have adopted eight out of eleven provisions that the shareholders are asking for, what do you do when you have a shareholder that comes in the following year and is just focused on one of those provisions, like aggregation? That is what has happened this year. You have a bunch of companies that have adopted proxy access that this year received shareholder proposals that were only focused on the aggregation provisions included in those bylaws. Most of those proposals were looking to require companies to allow larger groups of shareholders, up to 50 shareholders as opposed to 20, to aggregate their shares in order to satisfy the minimum ownership requirements of their proxy access bylaws.

There have been a number of no-action letters from the SEC that addressed those proposals, and they are very hard to parse. There are a number of letters that came out on February 10, and in about half of them the SEC granted no-action and about half were denied. I think it is now pretty clear that companies that have adopted proxy access that receive one of these proxy access 2.0 proposals can exclude them if they can demonstrate through a share analysis, which is what many companies have done, that the amendment being sought by the shareholder proposal will have an immaterial impact on the number of shareholders that can rely on the company's proxy access bylaw.

Finally, it's very clear to me that the pendulum from a regulatory perspective is swinging in the opposite direction. Historically there has been a broadening and expansion of the SEC's influence in corporate governance and in securities regulation more broadly. In light of the changes in administration, that pendulum is going to swing in the opposite direction, at least from a regulatory perspective. But I don't think that is the end of the story.

The other piece of the ecosystem that is corporate governance is shareholders. My expectation is that going into the 2018 proxy season, as companies begin to get shareholder proposals, companies will get more shareholder proposals than they have received historically and that there will be more shareholder advocacy than there has been historically.

In addition, if some of the Dodd-Frank-related rules that the SEC adopted or is considering are repealed or watered down, I would fully expect that shareholders will pick up those additional provisions or requirements and incorporate them into shareholder proposals. For example, more shareholder proposals on pay ratio, shareholder proposals on pay for performance, proposals on clawbacks, hedging—all of those things that shareholders may have taken for granted because they were part of the regulatory scheme implemented following Dodd-Frank. So the pendulum of shareholder activism may swing toward more activism. L

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**RESEARCH PATH:** ***Capital Markets & Corporate Governance > Proxy Statement and Annual Meeting > Shareholder Activism > Articles > Excluding Shareholder Proposals and Seeking No-Action Letters***