EY Center for Board Matters

Let's talk: governance

2014 proxy season review

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New developments raise bar for effective communication

In the fall of 2013, nearly 40 investor representatives shared with EY their key priorities for the 2014 proxy season: board composition (including skill set, diversity, and tenure and renewal), board elections and leadership, sustainability, executive compensation, and political and lobbying spending and oversight. This publication reviews how developments around these topics – and more – played out over the 2014 proxy season through shareholder proposal submissions, investor voting trends, proxy statement disclosures and behind-the-scenes company-investor engagement.[1]

- The season began with two of the largest US asset managers sending letters to portfolio companies outlining their expectations around governance practices and distinguishing their views from those of the proxy advisory firms. These letters signaled to companies that they should be prepared for engagement.
- Recognizing the importance of effective communication between companies and long-term investors – particularly given the increasing scope and influence of activist investors – more companies disclosed that they engaged with shareholders on corporate governance topics. Many companies also strengthened governance-related disclosures in their proxy statements through enhanced content, formatting and use of graphics.
- Company-shareholder engagement is a resource-heavy activity. Investors applaud the efforts of some companies to engage in a meaningful way, but note that engagements vary widely in quality and scope. Some investors are concerned that companies may begin to treat engagement as a check-the-box exercise rather than a genuine effort to communicate.
- The season concluded with the SEC staff issuing guidance on proxy advisory firms that, among other things, emphasizes the need for investment advisors to oversee the policies, practices and research of these firms.[2] This followed what the industry had already begun: proxy advisory firms are providing more tools for investors to implement policies specific to their unique views, and investors are becoming more vocal about their own policies and views on governance. These changes increase the need for companies to understand shareholders' varying perspectives.

Key developments in the 2014 proxy season

- Activist investors are becoming more active and influential.
- Attention is turning to board composition and renewal strategies.
- Company-investor dynamics are evolving as engagement becomes mainstream.

Ongoing proxy season trends

- Shareholder proposal submissions remain high, with a focus on environmental and social topics.
- Investor support for say-on-pay (SOP) proposals holds steady.
- Annual director elections by majority vote and independent board leaders increase across the market.

The report is based on EY Center for Board Matters' proprietary corporate governance database, ongoing conversations with investors, and insights from EY's Corporate Governance Dialogue Dinner series, which convenes institutional investors, directors and corporate secretaries to discuss key developments impacting the governance landscape.[3]

Key developments in the 2014 proxy season

Activist investors are becoming more active and influential

What's new?

Campaigns by activist investors are increasing in scope and influence. Nearly 150 campaigns by hedge fund activists were launched in just the first half of this year (the most since the financial crisis),[4] driven in part by an increase in capital allocated to these strategies. Both companies and long-term institutional investors are learning to navigate this changing landscape.

Activists are now:

- Targeting larger companies — no company or market is immune
- Advancing efforts through dialogue and collaboration with long-term institutional investors, including identifying companies with governance concerns as potential targets
- Developing more sophisticated sector- and company-specific analysis
- Using 14a-8 shareholder proposals and other proxy mechanisms to call attention to their concerns
- Winning more board seats, in large part through reaching settlements with the companies rather than going to a shareholder vote

How are companies responding?

Some companies are taking proactive measures to offset the influence of activist investors. This includes engaging institutional shareholders to develop relationships and understand their perspectives. It also involves assessing vulnerabilities (e.g., reviewing the capital structure, business portfolio, operational improvements, strategy, governance and board composition) and proactively addressing them, if appropriate. Increasingly, companies have shown a willingness to engage with the activists directly to consider their perspective and ideas.

With many activist investor campaigns targeting board composition and the relevant expertise of sitting directors, boards could benefit from connecting the dots for investors on how their composition is aligned with corporate goals and risk oversight responsibilities.

How are investors responding?

Some investors are formalizing internal policies on how they interact with activist investors, given the increase in activity. Many investors indicate that they want to hear from both the activist and the company in a campaign situation and will be in "listening mode" to gather information.

What does this mean?

Just as activist investor campaigns are rising, boards are at their most vulnerable in terms of structural anti-takeover defenses. Classified board structures, which can protect board continuity and make it more difficult for hostile acquirers to take control, have declined over the last decade or so. Just 32% of S&P 1500 companies have classified boards today, compared to 63% in 2000 (see also page 9). Similarly, only 12% of companies have a poison pill in place, compared to 54% in 2000. Some companies have found that engagement can provide a strategic opportunity to offset the influence of activist investors. A company that has had substantive dialogue with long-term shareholders around governance topics will know the likelihood of those investors agreeing with the activist's arguments and may be better positioned to secure their support.

Attention is turning to board composition and renewal strategies

What's new?

Both investors and boards are placing greater attention on whether the right directors — those with qualifications aligned with the company's strategic goals, stakeholders and risk oversight needs — are in the boardroom. Given the slow rate of turnover on boards historically, they are also focused on whether boards are regularly refreshing and providing an exit for directors whose expertise is no longer relevant.

Institutional investor focus in this area has mostly played out behind the scenes, through letters to boards and engagement discussions, and not through voting against director nominees. In 2014, investor opposition to director nominees was at its lowest in the last six years.

How are companies responding?

- Some companies are strengthening disclosures in the proxy statement on director qualifications, board evaluations, board diversity, and how the board approaches tenure and refreshment considerations. This includes using infographics, charts, and tables to provide this information in a readable and concise way.[5]
- A greater proportion of companies are bringing new directors into the boardroom, though refreshment remains slow overall.
  - Close to 850 directors joined S&P 1500 boards in 2013, up from just under 800 directors who joined in 2012 — a 7% increase.
- Some companies are involving directors in engagement conversations with key shareholders, which can enhance investors' view into board dynamics and individual director competencies.
  - Ten percent of S&P 500 companies disclose that they involved directors in engagement conversations with shareholders last year. Most often this included the compensation committee chair and/or members, followed by the lead director or board chair.

How are investors responding?

Investors are evaluating board composition and renewal differently. Some use company performance as the litmus test for whether the right directors are in the boardroom, either using company performance as an initial screen or allowing it to override any concerns over governance practices. Others use factors such as board tenure, turnover, diversity, skill set, independence and meeting attendance for assessing board composition.

To promote board renewal, most investors agree that rigorous board assessments, especially those facilitated by an independent third party, are most effective. Some investors may also support term limits, consider long-tenured directors to be affiliated in independence considerations, or support targets around board diversity thresholds. One leading asset manager recently adopted a director tenure policy under which companies are screened based on average board tenure as compared to market averages, which could result in votes against long-tenured directors or nominating committee members.[6]

What does this mean?

This focus on board composition is just beginning. Investors will likely continue to deliberate and develop differing views regarding which metrics are best for assessing board composition and which mechanisms are appropriate for encouraging board renewal. Companies will need to determine — and communicate to investors as appropriate — how they will pursue regular, strategic board refreshment. The recognition that board members serve only as long as their contributions are relevant and effective — and not simply until they reach retirement age — represents a broader cultural shift.

Trends in voting opposition to board nominees (% of all nominees)

Opposition level	2009	2010	2011	2012	2013	2014
More than 20%	9.8%	8.0%	5.1%	5.3%	4.7%	3.8%
More than 40%	2.1%	1.8%	1.0%	1.0%	0.8%	0.8%
More than 50%	0.6%	0.6%	0.3%	0.4%	0.3%	0.2%

Company-investor dynamics are evolving as engagement becomes mainstream

What's new?

Company-investor engagement on governance topics — and disclosure of these efforts in the proxy statement — continues to grow. While executive compensation remains the primary engagement driver, a variety of other governance topics — board and executive leadership, board composition and diversity, and sustainability practices and reporting, to name a few — are increasingly part of those conversations.[7]

How are companies responding?

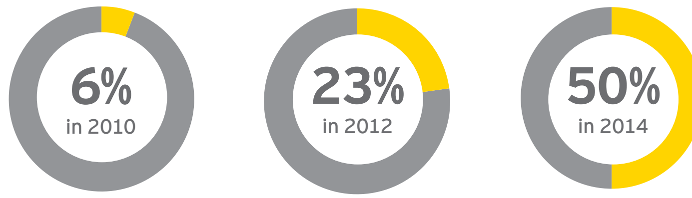
Company approaches to corporate governance engagement vary. Some have long-standing, engagement programs that include dialogue with a broad range of shareholders throughout the year, while others engage in response to a specific investor concern. Not all companies have considered engagement, and may even have resisted investor efforts to engage with them. Some of these companies remain cautious about Regulation FD, which prohibits selective disclosure of material nonpublic information. The SEC has made clear, however, that Regulation FD should not be a barrier to company-shareholder engagement on corporate governance topics.[8]

One of the keys to successful investor engagement is connecting with the right people: equity analysts and portfolio managers who are making investment decisions are often not the same individuals evaluating a company's governance and proxy-voting decisions. Companies that want to discuss governance topics should provide that their engagement does not remain restricted to regular communications with portfolio managers.

How are investors responding?

Large investors are beginning to evaluate their portfolios, capacity and goals to determine where best to direct engagement resources. The quality and scope of these engagements vary, and investors view some as a check-the-box exercise rather than a genuine effort to communicate. In particular, they are concerned that some engagement efforts are undertaken simply so that the company can disclose in the proxy statement that it engaged with its shareholders to earn credit from the proxy advisory firms.

S&P 500 companies disclosing engaging with investors



More than half (53%) of disclosed engagements resulted in companies taking action.

53%

Some smaller investors are still trying to get a seat at the table for engagement conversations and may rely on shareholder proposals and other proxy mechanisms to gain the attention of the board and senior management. This is because many companies focus engagement efforts on the top shareholders (e.g., the largest 20-50 holders) rather than expanding their outreach to smaller, but potentially more vocal, investors.

What does this mean?

Investors, particularly large asset managers, may start to decline some requests for engagement to focus on companies where they have governance concerns and engagement may be necessary for the investor to reach a fully informed voting decision. This increases the pressure on companies to make engagement meaningful and purpose-driven. Companies initiating engagement efforts should do so with a clear agenda and purpose.

Views from EY's Corporate Governance Dialogue Dinners

Insights on engagement in the age of the activist investor and evaluating boards from outside the boardroom

In June 2014, EY hosted a Corporate Governance Dialogue Dinner, bringing together institutional investors, board members, corporate secretaries and advisors to discuss the key themes coming out of the 2014 proxy season, including the rise in activist investor campaigns, greater focus on board effectiveness and oversight, and how these trends impact ongoing dialogue between companies and long-term investors.[9]

Key themes and takeaways from the dialogue included:

- Engagement for its own sake may be counterproductive. Investors may become more selective in their engagement efforts so that they can focus their attention on companies where they have governance concerns.
- Engagement can be a strategic opportunity to offset the influence of activist investors. To make engagement a strategic advantage, issuers need to understand and connect with the right individuals from the investor side, including governance teams and beneficial owners.
- Investors would like to know that the right people with the right skills are on the board, but they find it difficult to evaluate from the outside. Proxy statement disclosures provide only limited insights on board quality and director effectiveness. While engagement that involves directors can enhance investors' view into board dynamics and individual director competencies, these opportunities are generally limited. Many investors evaluate board composition using the metrics and methods available to them.
- Investors want to see disclosure demonstrating that boards have thoughtful, robust board evaluation and succession-planning processes in place. Having an independent third party facilitate director evaluations can be valuable, but it is ultimately incumbent on the board — led by the chairman — to act upon evaluation results.
- Part of the skill set needed to make company-investor engagement successful is the ability to understand the other side's perspective and have an open mindset.

Ongoing proxy season trends

Shareholder proposal submissions remain high, with a focus on environmental and social topics

In recent years, the number of shareholder proposal submissions has been at an all-time high, with proposals on environmental and social topics accounting for the largest category of proposals submitted at 45% of the total.

- Similar to 2013, close to one-third of all shareholder proposals submitted this year were withdrawn — and nearly 80% of those withdrawals were the result of company action and/or ongoing dialogue. These withdrawals were primarily on shareholder requests for annual director elections and enhanced sustainability reporting.
- Close to half of shareholder proposals voted on were supported by 30% or more of votes cast — the level at which most boards take notice. Around 15% of the proposals received majority support.
- Most proposals (80%) were filed by individual investors (30%), socially responsible investors (20%), public pension funds (16%) and labor funds (14%).[10]

What's new?

- Shareholder proposals seeking the appointment of an independent board chair were the most common request this year. Individual investors are now filing the vast majority of these proposals, a rate that jumped to 61% this year from 37% last year. Average support for the proposals was 31%, consistent with 2013 support levels. Proposals on this topic, as well as engagement, continues to drive changes in board leadership structures (see also page 9).
- Taken together, shareholder proposals on political and lobbying spending comprised 15% of all shareholder proposals. Support levels on these proposals vary widely, ranging from below 3% support to more than 50% support; three proposals secured majority support this year. While certain proposal variations attract more support than others, results on these proposals may vary because many investors evaluate these proposals on a case-by-case basis, considering the proposal's request as well as the company's disclosures, oversight policies and expenditures.
- Shareholder proposals on environmental-related topics can vary significantly, but at a high level, those focused on environmental sustainability averaged 25% support. Two of the more high profile proposals this year include:
  - Proposals asking companies across a broad range of industries to reduce greenhouse gas (GHG) emissions
  - Proposals focused on stranded asset risk, asking nearly a dozen companies in multiple industries to disclose risk scenario planning and potential climate change impacts to company business models

45% **of shareholder proposals submitted in 2014 focus on environmental and social topics**

Most common shareholder proposals submitted in 2014

	2014 Average support	2014 Proposals submitted	2014 Withdrawn
Appoint independent board chair	31%	75	11%
Disclosure and oversight of political spending	23%	67	24%
Disclosure and oversight of lobbying spending	25%	61	31%
Report on sustainability	25%	46	65%
Set and report on GHG emissions reduction targets	26%	43	49%
Adopt majority vote to elect directors	57%	42	29%
Eliminate classified board	84%	40	63%

- Proxy access — Fewer than 20 shareholder proposals on proxy access were submitted this year. However, those proposing terms based on the now-vacated SEC Rule 14a 11 (i.e., 3% ownership for three years) averaged 55% support, with six securing majority support. Conversely, the four proxy access proposals that went to a vote asking for less restrictive terms (e.g., 1% ownership for two years or groups of 25 or more investors with 1% total ownership for one year) averaged only 5% support. At least six companies have adopted proxy access procedures, and at least one other company has agreed to propose proxy access procedures next year.

Failure to implement a majority-supported shareholder proposal can lead to votes against incumbent nominees the following year.

- Some institutional investors are paying more attention to human capital, human rights assessments and related risk management across the supply chain. Around 15 companies in multiple industries were asked to report on their process for identifying and analyzing potential and actual human rights risks of company operations and supply chain; these proposals averaged close to 30% support.

Shareholder proposals receiving highest average vote support in 2014

	2010 Average support	2014 Average support
Eliminate classified board	62%	84%
Allow shareholders to vote on poison pill	56%	69%
Eliminate supermajority vote	74%	67%
Adopt majority vote to elect directors	56%	57%
Allow shareholders to call special meeting	43%	45%

Select regulatory updates related to corporate governance

SEC staff issues guidance on proxy advisory firms

Long-awaited SEC staff guidance on proxy advisory firms emphasizes the need for investment advisors to have policies and procedures in place to oversee the proxy advisory firms, including their research, practices and implementation of voting policies, so that proxies are being voted on in the client's best interest. Among other things, the guidance clarifies that investment advisors are not required to vote every proxy (or on every proposal). It also provides that proxy advisory firms must disclose potential conflicts of interest up front, noting that boilerplate language will not suffice.

The guidance likely will not impact the voting behavior of large investors but may prompt smaller investors to revisit their approach to voting or expend more effort around overseeing proxy advisory firms and reviewing votes cast. Proxy advisory firms' conflicts-of-interest disclosures will likely become more robust.

Business groups ask SEC to revisit shareholder proposal resubmission thresholds

This spring, the U.S. Chamber of Commerce, National Association of Corporate Directors, Financial Services Roundtable and six other business organizations petitioned the SEC to formally revisit the shareholder proposal "resubmission rule" and raise the voting support thresholds for when shareholder proposals may be resubmitted for inclusion in a company's proxy materials.[11] While some investors have indicated that they may be open to modest increases to the resubmission thresholds, they note that new shareholder proposals take time to gain traction and build broad support.

More SEC Dodd-Frank rules expected this fall

The SEC is expected to issue proposed rules in fall 2014 implementing portions of the Dodd-Frank Act concerning the clawback of incentive-based executive compensation under certain circumstances and disclosures on the relationship between executive pay and company performance. A final rule on the disclosure of the ratio of median employee pay to CEO pay is also expected in the fall.[12]

SOP support holds steady

More than 2,200 companies so far this year have gauged investor support for their compensation policies and practices through an SOP vote. This marked the second SOP vote for companies that elected triennial SOP frequencies. Overall support for these proposals remains high, averaging 91%, and so far only about 2% (or around 50 proposals) have not passed, which is consistent with results over the last two years.

While most companies respond quickly to low SOP votes, a handful of companies remain unresponsive to shareholder opposition to their pay practices. Over the past four years, 23 companies have not secured majority support for their SOP votes for two or more years.

What drives opposition to SOP?

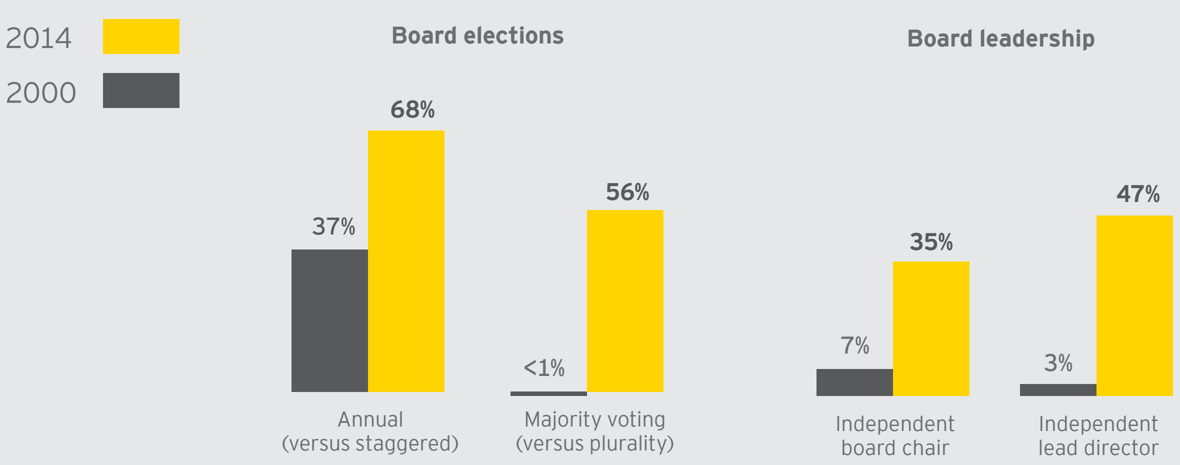
- **Pay-for-performance misalignment** – Company performance can impact support for SOP, especially if pay levels do not reflect declining performance.
- **Absolute pay** – In a small number of cases, the magnitude of payouts to senior executives is prompting some investors to consider absolute pay levels, regardless of company performance.
- **Problematic pay practices** – Some investors will vote against pay programs that incorporate one or more practices they consider egregious, such as tax gross-up payments and executive hedging/pledging of company stock. This generally applies in a limited number of cases, given that most companies have done away with these practices.
- **Performance metrics** – If there is a pay-for-performance misalignment or if pay is high on an absolute basis, some investors take a closer look at performance metrics used, how they tie to company strategy, and whether there is overreliance on a particular metric.

Annual director elections by majority vote and independent board leaders increase across the market

Many investors favor the annual election of all directors under a majority vote standard and want to see boards with a strong independent chair or lead director. Companies that do not have these practices, or that have lead independent directors lacking clearly defined, robust responsibilities, may be the focus of shareholder engagement or recipients of shareholder proposals.

Some large asset managers are encouraging companies to adopt annual director elections and majority voting through letters to boards and engagement conversations. Most investors are unified in their beliefs – and will support proposals across the board that implement annual elections and majority voting. (See also page 6.)

Evolving governance practices at S&P 1500 companies[13]



Toward more meaningful communications — and disclosure

As investors increasingly turn their focus to the boardroom and continue to use shareholder proposals to effect governance changes, it is important that company communication efforts — through direct dialogue with investors and proxy statement disclosures — become more effective. The way forward is likely more focused and purpose-driven company-investor engagements and more meaningful proxy disclosures that avoid boilerplate language and utilize infographics, enhanced design and substantive executive summaries as appropriate.

Endnotes

1 In fall 2013, EY's corporate governance team had conversations with nearly 40 institutional investors about their governance priorities for the 2014 proxy season. Participants included large asset managers, faith-based investors, labor funds, public funds, socially responsible investors, and investor associations and advisors. *Let's talk: governance — 2014 proxy season preview*, EY, April 2014.

2 *Staff Legal Bulletin No. 20 (IM/CF)*, Securities and Exchange Commission, 30 June 2014.

3 All data is from EY's Corporate Governance Database and covers the Russell 3000, unless otherwise noted in the text. Data is based on meetings through 30 June 2014.

4 "Returns From Activist Hedge Funds Are Causing a Stir," *Wall Street Journal,* 7 July 2014

5 *Let's talk: governance — Companies respond to calls for more meaningful governance disclosure*, EY, May 2014

6 *"Addressing the Need for Board Refreshment and Director Succession in Investee Companies,"* State Street Global Advisors, 2014

7 *Let's talk: governance — Companies respond to calls for more meaningful governance disclosure*, EY, May 2014.

8 In her *remarks at the 10th annual Transatlantic Corporate Governance Dialogue*, 3 Dec 2013, SEC Chair Mary Jo White said that "engagement with shareholders should mean more than just mailing out the annual proxy statement and conducting the annual meeting. It should mean proactive outreach, and clear, direct, and honest communications about how and why decisions are made … And the board of directors is — or ought to be — a central player in shareholder engagement." Also *see Regulation FD, Update 4 June 2010*, SEC.

9 The discussion took place under the Chatham House Rule.

10 Based on primary filer, as available. Many proponents co-file shareholder proposals, including with proponents from a different category.

11 *"Petition for Rulemaking Regarding Resubmission of Shareholder Proposals Failing to Elicit Meaningful Shareholder Support,"* SEC, 9 April 2014. Under the current rule, companies may exclude a proposal if it failed to receive 3% support, if voted on once in the last five years; 6% support, if voted on twice within the last five years; or 10% support, if voted on three or more times within the last five years.

12 *"SEC Agency Rule List — Spring 2014,"* Office of Information and Regulatory Affairs.

13 Year 2000 data based on Investor Responsibility Research Center, Board Practices/Board Pay 2002.

Let's continue the conversation.

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