Teneo

Insights

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Proxy Season 2018

Navigating New Rules, Ratios and Realities

A discussion between Dr. Martha Carter, Head of Teneo Governance
and Sean Quinn, Senior Vice President with Teneo Governance.
Moderated by Kevin Kajiwara, Co-Head of Teneo Intelligence.

Dr. Martha Carter and Sean Quinn discuss significant developments in corporate governance, drawing on their decades of proxy advisory experience to provide advice on navigating through some of the challenges of the 2018 proxy season, including: CEO pay ratio, the increased focus on activism, investor and proxy advisor engagement, expectations of the board, and the prominence of ESG issues for investors.

Kevin Kajiwara (KK):

Thank you for joining our latest Teneo Insights call. The topic today is the 2018 Proxy Season and what you need to know going into it.

I'm Kevin Kajiwara with Teneo Intelligence in New York and I'm joined by two of my colleagues today who are very well placed to discuss these issues. Dr. Martha Carter is a Senior Managing Director at Teneo and she is the Head of Teneo Governance.

Teneo Governance advises CEOs and boards of both public and private companies on corporate governance best practices on activism defense, executive compensation, shareholder engagement, strategy and any other matters that come before the board.

Martha currently sits on the Advisory Council of the Harvard Corporate Governance Forum. Prior to joining Teneo, she was the Head of Global Research at Institutional Shareholder Services (ISS) and she was the founder and chair of the ISS Global Policy Board.

Martha is joined by one of our colleagues, Sean Quinn. Sean is a Senior Vice President with Teneo Governance. He sits on the Markets Advisory Council at the Counsel of Institutional Investors. Sean also joined from ISS. He was an executive director there and the Head of U.S. Research.

Martha, let's begin by having you highlight some of the key themes and issues for 2018. What are the big trends that you foresee this year?

Martha Carter (MC):

So, the big backdrop key theme, of course, is the macroeconomic drivers. They are the story this year. We all know the markets have been strong, certainly in 2017.

The volatility that we've seen, especially in the last few days, is a good news, bad news story. It is creating some good news and some positive investor optimism, but also some vulnerabilities for companies.

That's certainly the case around pay issues. Pay for performance alignment is always a big issue every year and performance has been good. But we might see some questions around bonus awards, for example, particularly if some of the markets gains don't continue for companies.

So, investors are going to scrutinize pay and Sean will talk a little bit more about pay later on. But also, regarding capital allocation decisions, firms are repatriating cash and lots of it. There'll be firms on the hunt for acquisition opportunities, firms that are doing buybacks, dividends.

Companies need a strong narrative around cash and what they're doing with cash. Activists might find companies that

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don't have a good story around cash and that can create vulnerability. There's also a danger zone in the economic drivers being the story, because that means that companies don't really control the narrative. It's being controlled by macro factors and there's a danger in that, because companies could potentially sit back and let the economy tell their story for them, so keeping up with communications and keeping up with engagement are important in these volatile markets, whether it's on pay, board issues, shareholder proposals, capital allocations, cyber risks or any of these issues, continuing that level of communication and dialogue with investors is going to be really important.

Then there is the whole general gridlock on the political and regulatory front. Not much (outside of the tax reform and then CEO pay ratio) is going to happen on the shareholder initiatives front and investors will tend to use the shareholder proposal process to seek some of the objectives that they want to gain. And where are they likely to go with that shareholder proposal process? Climate change, diversity reporting, and this is an election year, so that's always a good year for lobbying proposals as well.

Large asset managers' views on ESG issues are also evolving. Institutional investors, like BlackRock and Vanguard, are showing that they are interested in environmental and social issues along with governance issues, and they're baking them into their expectations for portfolio companies. BlackRock has played its usual role, I think everybody on the call probably knows that. Their an annual harbinger of proxy season, with Larry Fink's annual letter calling on companies to deliver both financial performance, as well as social value.

And then cyber risks and data breaches are always there: directors of companies hit by cyberattacks could face additional scrutiny during proxy season.

And speaking of directors, let's cover board issues. They're always a prominent theme in any proxy season, investors take a close look at the boards and that's going to continue. There are some important notes on the board composition and the board structure side that are worth mentioning.

First up, we've talked for a number of years in the governance space about director skill sets, about matrices, experience, that's going to continue, but this is the year of the #MeToo Movement, so the issue of diversity is at the forefront, particularly women on boards, and that's poised to feature prominently in 2018. So, if you are in a company where the board has few or no women on the board, you can expect some type of flagging by investors at a minimum, or potentially even some targeting for lack of diversity. And just a quick statistic on that one, the 2020 gender diversity index reported that in 2017, the percentage of women on boards was almost 20 percent for the Fortune 1000 and that number has been increasing year-over-year. So, if you're not in that range, you might want to take a close look at board diversity and ensure that in your proxy statement, you've got a good explanation as to why your company doesn't meet that standard.

Speaking of proxies and disclosures, prior disclosures from last year should not be considered sufficient, especially if you find yourself in the position that you need to engage with investors, which most companies do. You might find that these investors want more drilldown, whether it's into director bios and skills, the refreshment process, or the nomination process.

A lot of shareholders are looking at the refreshment process and seeing a lack of refreshment as an indication that there might be a barrier to achieving that board diversity.

Investors are also looking closely at long-tenured directors. Lately it seems like the line in the sand on board tenure is the ten-year mark. Individual tenure, board leadership tenure, those that sit on key committees and play roles with chairs on key committees all receive greater scrutiny from investors when they have served for a decade or longer.

All of that leads back to that diversity issue. Other things that investors are going to scrutinize are the individual directors; scrutiny for this has never been higher. So, all boards should, of course, perform those annual assessments to ensure the right mix of skills.

Another interesting statistic comes from PWC's most recent annual corporate director survey, the one for 2017, which states that 46 percent of directors believe that someone in the board room needs to be replaced. Think about that. Almost half of the directors surveyed looked around the board room and thought "somebody needs to go." Directors are very knowledgeable when it comes to understanding the amount of work that needs to be done and the demand from the boardroom.

Directors also need knowledge of the strategic plan. Board members should have all the relative information on value creation prospects whenever they're engaging on with investors. Whether it's acquisitions, activism, proposals and pay issues for the (comp) committee, the director should be well prepared to discuss these topics in their engagements.

And speaking of pay, we've got the CEO pay ratio issue, to talk about, which has been one of the biggest developments for 2018. We've certainly heard a lot from our clients about it. And for that I'm going to turn it over to Sean to talk about.

Sean Quinn (SQ):

We've spoken with many companies and of course they're asking not only about the rules around the new pay disclosure, but also the communication around the ratio when it is published, both external communication to investors and the media, as well as how to handle internal communication to their employees.

Companies are required to disclose three numbers in their proxy statements: total CEO pay, median employee pay, and the ratio of the two. They are also required to show the methodology used to calculate the median employee's compensation. Companies reporting on a calendar year basis would be the first to disclose and we'll start seeing data when these companies begin filing their proxies in late February or early March.

It's unlikely pay ratio data will factor into investor voting decisions in 2018. Investors won't be able to make peer comparisons or year over year evaluations. There's not much investors can do with the new disclosure. Likewise, ISS and Glass Lewis have declined to tie their voting policies to pay ratio data. That said, we expect that the disclosure will draw a lot of attention from media, because media generally reviews and reports on CEO pay. And employees will have the opportunity to compare their compensation with the company's median employee compensation - and against median pay at competitors. Company-specific factors, like recent acquisitions and headcount reductions, can cloud the picture. So, it's very important that companies have a communications strategy around the CEO pay disclosure in order to minimize the risk of unwanted publicity.

Then, of course, companies will also have to ensure that pay and performance are aligned, otherwise they risk negative votes on their Say-On-Pay proposals.

With the markets reaching highs, we could see some significant pay packages this year, but investors and proxy advisors will review pay from a benchmark perspective, looking at performance versus peers.

The proxy advisory firms both have quantitative tests that look at the relative degree of alignment and pay. It's important to note that any Say-On-Pay proposals that have negative votes in the 30 percent or more range will need a response.

Some of the important things companies can do to best reflect their pay program include connecting the dots in the CD&A. It's a good idea to highlight key changes to the program from the prior year, including changes to the incentive plan metrics. Also, make sure that the narrative is clear. Companies should describe how incentive plans are tied to keeping business objectives on track.

It's also good to provide an explanation or rationale for numbers that might appear to be exceptional. A good example of this is some companies will award equity only every two or three years. So, if a large grant is designed to cover multiple years, it's good to make this is clear to the reader.

And of course, it's always good to engage with proxy voting staff of key shareholders. Following these steps can help companies to avoid additional and unnecessary scrutiny.

KK:

It sounds like executive compensation is going to be front and center during the proxy season and as Martha said at the outset, board issues are perennially prominent. As we head into the year though, what else is kind of trending here, Martha? You previously mentioned activism, particularly if there's large piles of repatriated cash.

MC:

That's right and those two go hand in hand for sure. Activism has not let up, so we've got to spend a little bit of time talking about that.

We're already seeing some pretty high-profile contest activism scenarios teeing up for this proxy season. Broadcom did for Qualcomm, for example, and really the gloves are going to be off for this proxy season.

So, what can we expect? Activists are targeting bigger and bigger companies - we've certainly seen that from the recent examples - and it probably will be no different this year. No company is too big for an activist attack, we've certainly established that.

The other interesting thing is, it's safe to say the activists are using more creative tactics to gain board seats including, for example, seeking the ouster of the CEO or supporting the re-nomination of a defeated incumbent, or announcing an activist-owned CEO candidate. We've been seeing activism on the rise for the last decade. And in the past, we've usually seen a bit of a hands-off approach to the CEO change.

It's a high bar for proxy advisors for shareholders to get their heads around the CEO change, because it can be very disruptive on a number of fronts, but activists are tending to more frequently use this tactic as a strategy, and investors tend to like to see stability and lack of disruption in leadership, but are open to listen if an activist comes along and can successfully argue that a CEO is a roadblock to making needed changes.

Regarding activists that are already on boards, some of them are leaving for any number of different reasons, so if you are watching this from afar, it's important to take a look at the reasons. If you are experiencing this up close, it's important to articulate those reasons.

Some activists are leaving deliberately to cut ties with agreements so that they can leave open their options potentially to launch a contest. Others because their work is done; others because they simply don't have the time and they're handing it off to somebody else.

And activists also are now fluent in governance, they're fluent in the long-term value creation dialogue; they heard some of the criticisms over the past few years about short-termism, so they've got better at their level of discussion and engagement with investors and with proxy advisors.

And speaking of proxy advisors, in a proxy contest they can often subscribe to what we call the "what's the harm theory?" So, if a dissident's slate is on the ballot, we've seen a lot of cases where they seem to like to split the vote and advocate for a few of the boards for the dissidents but not all of the board seats, as a "second pair of eyes."

So, you really have to ensure that the boardroom is functioning; that all the board seats are really well established and that each board member has a role, especially in the case of a proxy contest. If there is a fierce proxy contest, and the addition of activist directors, it can definitely create a stalemate in the board room post proxy contest.

We've already mentioned some of the significant macro drivers this year; the new U.S. tax law regarding repatriation of cash certainly is going to lead to an uptick in M&A interest and activity, including potentially contested M&A and balance sheet activism that will come along with that. What do companies do now to reduce their vulnerabilities to attack? Well this is a really good time to do a few things, which is be very clear in the earnings calls, some of you have already had them; some are upcoming and be very clear with some good disclosure in the proxy statement. And those should all have a consistent theme in messaging, particularly around the strategy for the company.

A lot of clients who we've been working with lately also want to refresh their websites. Some of the websites have been in "set it and forget it" mode, and it's important to update for diversity; for ESG issues; for CSR reports; highlighting the board; creating key things in mission statements; being clear on strategy.

It's important to engage with investors ahead of the annual meeting; to meet with the proxy advisors, particularly if you have issues and if you know that those issues are going to create triggers against some of their policies. Sean what else have we seen?

SQ:

One of the biggest macro trends we've seen is the increasing investor interest in corporate social responsibility. If you look back several years, you've seen how environmental and social-themed shareholder proposals have gained both in frequency and support levels.

We can remember back when governance proposals outnumbered environmental and social proposals, but we've since seen that come close to flipping. Last year saw a number of majority shareholder votes for environment-themed proposals at energy companies. We also saw an uptick in the number of diversity-themed shareholder proposals, which could continue this year, fueled by the #MeToo Movement. In December, a gender and racial diversity shareholder proposal filed at Silicon Valley-based Palo Alto Networks, received a majority of the shareholder vote, which again suggests that support for these proposals could increase in 2018.

It's worth noting that investors expect more and more of boards nowadays. They expect boards to have a command of the risks companies face: environmental, human capital, reputational, and to have the processes and structures in place to manage these risks. I think many proposals that we'll see this year will stem from investor concerns that boards' understanding of these risks (or disclosure around these risks) is not sufficient. That being said, companies can leverage corporate social responsibility as a differentiator and as a value enhancer so companies can mitigate potential concerns.

They can enhance their website to highlight some of their policies and initiatives; they can link corporate social responsibility to company strategy.

Some companies have even tied a portion of executive compensation to CSR-related metrics.

KK:

Let's get down to some brass tacks here because you both have covered very comprehensively the big trends and themes that we're seeing this year, but as we head into the season, Sean, what are some of the specific voting items and proposals you're expecting or watching?

SQ:

As I just mentioned, environmental and social proposals will be front and center this year, especially those that address sustainability, board diversity, gender pay equity and lobbying disclosures.

Most in the governance community know that the Office of the New York City Comptroller has led some of the most extensive shareholder proposal initiatives. A few years ago, they launched their Board Room Accountability Project and filed dozens and dozens of proxy access shareholder proposals, and were quite successful. This year, they've launched their Board Accountability Project 2.0, which is aimed at increasing diversity and independence and climate awareness in the boardroom.

They've contacted about 150 companies requesting two things: first, a standardized board matrix in the proxy statement disclosing the race, gender and skills of each director, and second, a discussion of the board's refreshment process.

We've also noticed that investors working through the Midwest Diversity Coalition are sponsoring proposals asking for a Rooney Rule provision in nominating committee charters. These provisions are modeled on the National Football League rule and would require all board searches to include diverse nominees.

Last year, shareholder proposals asking for companies to report on the risk of the climate change policies won majority support at three companies and received more than 40 percent at 10 other companies. That's astounding for environment-themed proposals, and given the success we expect to see a bumper crop of proposals related to sustainability and climate change in 2018.

There's also an organization called Investors for Opioid Accountability, a coalition that's asking manufacturers and distributors of opioids to report on the business risk related to their products. And they're also filing proposals calling for independent board leadership, which they think is a potential risk-mitigator.

Lastly, the Interfaith Center on Corporate Responsibility has filed shareholder proposals at several pharmaceutical companies related to the link between executive pay incentives and the affordability of prescription medications. So, these are the key initiatives we'll see during proxy season.

KK:

Well that's a good recap of the interesting array of issues we're seeing on the investor side. Martha, what about the proxy advisors?

MC:

Sure, let's talk about proxy advisors. So, Kevin mentioned at the outset that Sean and I both worked at ISS for many years. We lived through a lot of the policy developments and policy changes, such as Dodd-Frank, the advent of Say-On-Pay majority voting.

As of late, there haven't been too many policy changes from proxy advisors compared to those years of rapid pace change and development. And it's because most of the major issues in the governance world are already out on the table. Obviously, we've got things like diversity that are still growing stronger. We've got CEO pay ratio this year. But the discussions around one-share-one vote, around investors having Say-On-Pay, and so on, are already out there. So, there hasn't been much in the past few years to talk about, besides a few key issues. I mentioned CEO pay ratios being out there, but not really for this year in terms of their policies because proxy advisors rely on a lot of data. So, look for them to gather up all that proxy season data and all those CEO pay ratios over the summer and potentially bake those into policies for next year.

So, what's coming up for this year? It's consistent with some of the themes that we've already been talking about on this call, diversity for example - ISS is going to highlight boards that show a lack of gender diversity this year. But they will not make an adverse voting recommendation due to a lack of gender diversity in 2018. So that opens the door for a multiyear policy where they may do something in 2019. Glass Lewis also came out on board diversity, with a bit more specificity on their side. They're going to feature increased discussions of board gender diversity in their reports and they are very specific about having a phased in policy that looks at nomination committee chairs and potentially targets them with negative recommendations if boards do not include a female director or provide an explanation as to why not, by 2019.

So, take 2018 to get your house in order, but you might face some negative votes in 2019 without any kind of gender diversity on the board. Another issue is the gender pay gap.

ISS came out with a policy that's case-by-case, regarding requests for reports on a company's pay data by gender, or a report on their policies and goals to reduce the gender pay gap.

And as usual, in most of ISS's case-by-case determinations on shareholder proposals, they take into account a number of factors including: their current policies and disclosures by the companies, their philosophy on comp practices, and they'll also consider whether or not the company has been the subject of any kind of controversy or litigation.

And then one issue that hasn't really come up too much over the past number of years is on nonemployee director compensation. But ISS has a policy on it this year. And that is because most investors recognize that the role of the director has become increasingly more time-consuming and more difficult. And there hasn't been a lot of uproar on director pay with few exceptions, of course.

ISS may recommend against directors being responsible for setting nonemployee director pay when there is a pattern of excessive nonemployee director pay without a compelling rationale. So that leads to the two obvious questions:

what's a pattern and what's excessive? The pattern they're describing is over two or more consecutive years, which implies that nothing's going to happen in 2018, so this policy really doesn't become effective until 2019. What's excessive? Well, that appears to not have a bright line test against it, but for large cap companies, it appears that pay over a million dollars for a nonemployee director might likely result in some enhanced scrutiny.

And then finally, a note on virtual meetings. We've had several of our clients talk to us about virtual meetings. Glass Lewis has a policy out on that also a phase policy on virtual meetings which from 2019, not 2018, but 2019 will hold governance committees accountable, if shareholders aren't offered the same rights and the same opportunities to participate in a virtual meeting as in a physical meeting.

KK:

So what are the key takeaways for companies after hearing these trends you've been discussing?

SQ:

Here are a few suggestions. Companies should always make sure that their proxy materials and website are refreshed. It's good idea to review director bios with fresh eyes to make sure that they're current, but also to make sure that they present director skills and experiences in the best light. One way to do this is to add a board matrix to show that the board's composition is robust. Also, it might be worth considering adding or updating language on board refreshment.

It's also a good idea to consider a communications plan for pay ratio disclosure that covers the internal, as well as the external audience.

We also mentioned earlier that doing a review of the vulnerabilities and skills gaps is a good exercise, particularly with the focus on diversity and skill sets. Vulnerabilities include having a lot of long tenure directors, which could suggest that board refreshment might be inadequate. Director age is also becoming more of a potential vulnerability. Having a lot of directors age 70 or above, especially in leadership positions, could raise questions around board succession.

And as Martha noted, investors are increasingly interested in skill sets and gaps, so boards should regularly review their skills against the current business mix and company strategy.

And lastly, companies should reexamine the governance structure for potential vulnerabilities. They should be sure that their governance structure, including features like shareholders' right to call special meetings, make sense for the company given its size and shareholder base. Anything else Martha?

MC:

Let's spend just a minute or two talking about engagement, which is so important, particularly in the backdrop of all the things that were just mentioned.

Revisit your engagement plan (assuming everyone has one by now) because we've been talking about engagement and governance for a number of years, and also because there has been a lot of turnover at proxy advisors and at investors. So, those folks that you might have spoken to last year at a proxy advisor or one of your shareholders might not be there this year, or you might find that they're sitting in a different role.

For your engagement plan, in addition to keeping up with content, you also want to keep up with your contacts and make sure that the people you're talking to are the current ones and are the right ones.

Topics that we discussed already and likely opportunities for engagement include: CEO pay ratio, which is at the top of the list. Capital allocation, buybacks, spending cash, M&A, dividends and diversity are also going to be big issues this year and probably will result in many engagements between companies and proxy advisors.

Board skill sets, the human capital issues, we talked about, gender pay and the ESG issues and the role of boards, they should be part of the engagement.

It's expected and I think companies generally do this for high-profile situations, but they also need to ensure that it's done in other cases as well. Boards need to be able to tell shareholders about all the work that they're doing and sometimes that doesn't make it into the proxy statement or into some of the disclosures.

But, they do a lot of work on behalf of investors and having them in some of those engagements, for example, if you're doing a CEO pay ratio engagement and you bring in one of the comp committee members, that type of an engagement, while it might not be absolutely necessary, builds up goodwill with shareholders and can certainly help in other circumstances as well.

KK:

I'm going to exercise my Teneo Intelligence hat over here Martha, because what you've been talking about has been really focused on issues for U.S. companies. I'm just wondering how much difference there is in the governance trends you're seeing this year as you look beyond the U.S.?

MC:

Many of the key themes really remain the same. But certainly the regulatory practices, the market practices, they can vary widely across regions and across countries. But gender issues, we've been talking about diversity quite a bit and the #MeToo Movement, that is global.

The human capital concerns, gender pay gap discussions, those are global. The macro trends, I started out the call with the backdrop regarding the macroeconomic drivers, those also have a global impact.

And of course, the increased focus on activism, while activism and a lot of the hedge funds have their genesis in the U.S. market, nevertheless, it is a global discussion.

No country, no company is immune to activist attacks, activists are searching for even more opportunities and more targets, and that means going overseas for some companies or some countries that likely have more favorable financial conditions or regulations for them.

Another global issue to consider is that many countries are undergoing tremendous regulatory change. Think anti-corruption legislation for example, being adopted, that's a good example of one of the global effects on companies and particularly on boards; they have to clearly show the level of compliance and oversight and the duties that they're performing under the new rules and regulations.

And then we talked a bit about ESG. There's countries like Australia that are really emphasizing their companies social license to operate. More emphasis on companies demonstrating their focus on social factors, such as pay disparity, as well as on those financial factors. And speaking of pay, Sean I'll just let you jump in with any further remarks.

SQ:

Regarding Say-On-Pay, the Say-On-Pay ballot item was an import to U.S. from other countries. It existed in the U.K. for years before it came to the U.S. So, the idea of shareholders having a vote on executive pay has been around for a long time.

This year there are a few markets with new pay regulations. In France, there is a binding vote on pay and gender pay gaps and pay ratios in the U.K., but the key theme of pay for performance is worldwide.

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