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A Proxy Season Guide to 2019

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Now that the holidays are in the rearview and business as usual has begun to pick up where it left off, it's time for public companies to do a deep download of key securities law updates and business developments of the past year so they are positioned for success in 2019. Below is a review of the 2018 proxy season, along with a summary of new and anticipated changes that may impact reporting and disclosure requirements for the 2019 proxy season.

2018 IN REVIEW

The results of every proxy season tell a story. The 2017 proxy season was a time of change, reciprocal activism, and engagement, with a momentous focus on environmental, social, and governance (ESG) issues. That energy continued into 2018 and the story is a complex one. Though ESG continued to gain momentum, with high levels of support and a record number of withdrawn proposals, the vast majority of ESG proposals failed. Despite this majority failure, the increased support for ESG proposals is a strong indicator these issues are material to shareholders and will likely continue to be so. Proposal topics that secured majority support included, among others, climate risk, coal-related risks, greenhouse gas emissions, gun safety, the opioid crisis, and sustainability reporting.

Despite the foregoing, average rates of shareholder support did not change measurably. However, investors continue to place greater importance on a wider range of topics, including the aforementioned ESG issues, proposals on say-on-pay, special meeting rights, independent board chairs, and the ability to act by written consent, as well as a number of proposals related to significant cultural and social movements and trends. Proposal topics addressing say-on-pay received steady support at around 91 percent across the board, perhaps in response to increased payouts and CEO pay. Yet, on average support was the same at companies where the CEO pay ratio was disclosed as it was at companies that were not required to disclose the pay ratio. In contrast, the number of proxy access proposals has continued its steady decline. Overall, proposals garnering the most support were concerned with ESG or corporate governance issues.

Institutional investors continued to focus their attention and efforts on board composition, long-term performance and sustainability, and solidifying the link between compensation and strategy. The focus on board composition included topics such as tenure, but the big shift has been toward diversification, more specifically, gender diversity of the board, with some major institutional investors including gender diversity expectations in their agendas. There also continues to be a steady increase in institutional investor support toward ESG and corporate political spending proposals. This notwithstanding, institutional ownership of public company shares declined slightly to 70 percent (from 71 percent in 2017). Though not significant enough to be a telltale sign of a downward trend in institutional ownership, it may be worth monitoring.

Though each year, and each proxy season, brings some level of change, the 2018 season looked and felt like a year full of preparation, but only the start of shareholder action, and such action is no longer merely reactionary. Indeed, in light of all of the sexual misconduct scandals publicized in 2018, institutional shareholders have begun taking preemptive action. For example, BlackRock is prioritizing human capital management and the California Public Employees' Retirement System has since proposed changes to its corporate governance principles to address this widespread problem. Reactive or preemptive, this theme of shareholder engagement will likely continue into 2019, and public companies, as well as their directors and advisers will need to decide whether and how best to respond.

2019 IN PROCESS

While there are no major new reporting or disclosure requirements for the 2019 proxy season, there are several key developments to take into account and become familiar with when preparing company proxies and annual reports.

Division of Corporation Finance Issues Compliance and Disclosure Interpretations (C&DIs)

In May 2018, the SEC's Division of Corporation Finance issued 45 new C&DIs to replace the interpretations in the Telephone Interpretation Manual and the March 1999 Supplement relating to the proxy rules and Schedules 14A and 14C. Some of the substantive changes touch on cumulative voting, non-Rule 14a-8 matters, name changes, issuance of additional common stock, new plan benefit tables, and elimination of preemptive rights. There were also several technical changes, including changes to address the need to disclose information required by Items 7 and 8 (director and executive officer compensation and other information) with respect to directors not up for election in connection with proxy statements for a special meeting to elect a new director. While these new C&DIs are generally consistent with the interpretations they replaced, certain changes may impact the 2019 proxy season. For example, C&DI 124.07 provides a company must file preliminary proxy materials if it receives adequate advance notice of a non-Rule 14a-8 matter that may be raised at a meeting if Rule 14a-4(c)(2) does not permit the company to exercise discretionary authority on such matter.

Then, in July 2018, the Staff issued two additional C&DIs relating to notices of exempt solicitations. C&DI 126.06, for example, explains the proxy rules only require a notice of exempt solicitation be submitted by a soliciting party that beneficially owns more than $5 million of the class of securities subject to solicitation and further specifies the Staff will not object to a voluntary submission of such notice as long as it is submitted with a cover that clearly states notice is being provided voluntarily.

Division of Corporation Finance Issues Additional Proposal Guidance

The Division of Corporation Finance published guidance in 2017 providing information and its views on when it is reasonably acceptable to exclude a shareholder proposal from the company's proxy statement (Staff Legal Bulletin No 14I (SLB 14I)). This ability to exclude may be exercised if a proposal does not have "economic relevance to the company's business" pursuant to Rule 14a-8(i)(5). However, in its Staff Legal Bulletin 14J (SLB 14J) issued in October 2018, the Staff gave additional guidance about factors it considered most helpful in describing a board's rationale for excluding a shareholder proposal on the basis of "economic relevance." These factors may include:

- The extent to which the proposal relates to the company's core business activities;
- Quantitative data, including financial statement impact, related to the matter that illustrate whether a matter is significant to the company;
- Whether the company has already addressed the issue in some manner, including the differences – or the delta – between the proposal's specific request and the actions the company has already taken, and an analysis of whether the delta presents a significant policy issue for the company;
- The extent of shareholder engagement on the issue and the level of shareholder interest expressed through that engagement;
- Whether anyone other than the proponent has requested the type of action or information sought by the proposal; and
- Whether the company's shareholders have previously voted on the matter and the board's views as to the related voting results.

Companies who decide to exclude a shareholder proposal on the basis of the fact it is not economically relevant should carefully consider these factors in preparing a "no action" request.

SEC Issues Interpretative Guidance on Cybersecurity Risks

In February 2018, the SEC issued an interpretive releaseproviding cybersecurity guidance to assist companies in preparing their disclosures about cybersecurity risks and incidents, if any. This interpretive release discussed the nature of cybersecurity risks and ultimately indicated that oversight and management of such risks may be vested in upper management, the board, a committee of the board, or some combination thereof. Further, whether cybersecurity risks should be disclosed by the company depends in large part on whether the risks and issues are material to the purpose of the company.

Overall, some considerations companies should consider this proxy season are: (1) the SEC, perhaps more than anything, is focused on timely and accurate disclosure and maintenance of the company's internal systems of control; and (2) in assessing their obligations to disclose, companies should undertake this assessment in relation to its other risk factors and disclosures, as well as any other actions or precautions the company has taken in response to, or prevention of, cybersecurity breaches and incidents.

One point of reference companies can utilize in the 2019 proxy season and for future reporting is the National Institute of Standards and Technology's Cybersecurity Framework (NIST), which NIST

revised and released in April of last year to assist companies with this relatively new, but fast developing, area of risk, affecting companies of all sizes across industries and borders. Another often overlooked resource is the Federal Trade Commission (FTC) work on data security, including its guide for business based on lessons learned from FTC cases. These resources are great complements to one another; the NIST framework helps businesses with risk assessment and mitigation, which is essentially what the FTC requires.

Expanded Availability of "Smaller Reporting Company" Designation

Effective September 10, 2018, the SEC expanded "smaller reporting companies" (SRCs) under the disclosure rules. An SRC designation enables a company to take advantage of less arduous reporting and disclosure requirements. SRS status is determined by a "public float" test or a revenue test (each as determined as of the company's second quarter). Under the public float test, companies with public float of less than $250 million may qualify as SRCs. For the revenue test, companies with less than $100 million of annual revenues and no public float, or public float of less than $700 million, may qualify as SRCs and therefore be eligible for reduced requirements.

SEC Adopted Rule Requiring Public Companies to Disclose Practices and Policies Regarding Abilities to Hedge the Company's Equity Securities

On December 18, 2018, the SEC adopted a rule that requires companies to disclose whether they have adopted practices or policies regarding the ability of their employees (including officers) and directors to hedge the company's equity securities. The rule implements Section 955 of the Dodd-Frank Act and is intended as an informational tool for stockholders. Although this new rule is not in effect for 2019, companies should take it into account when considering their practices, policies, procedures, and disclosures about or related to hedging. Public companies that are not SRCs or emerging growth companies (EGCs) must comply with the disclosure requirements in proxy and information statements relating to the election of directors during fiscal years beginning on or after July 1, 2019. SRCs and EGCs must comply with these disclosure requirements for fiscal years beginning on or after July 1, 2020.

Finally, as a reminder to companies, there is no new median employee determination needed this year for CEO pay ratio. In addition, as the Internal Revenue Code's Section 162(m) performance-based compensation exception has been eliminated by the Tax Cuts and Jobs Act, companies should take the opportunity to review its implication to the company's proxy disclosures and reporting.

GOVERNMENT SHUTDOWN UPDATE

Due to the partial federal government shutdown, a "limited number" of SEC Staff members will be available to respond to emergency situations involving market integrity and investor protection and answer questions regarding filing fees, but they will not be able to answer other questions. While issuers may still offer securities under certain limited circumstances, the Staff will not consider requests for acceleration or qualification of registration or offering statements.

EDGAR – The EDGAR filing system will continue to operate during the shutdown and will continue to accept periodic filings, registration statements, and offering statements.

Proxy Statements – Issuers that must file a preliminary proxy statement during the shutdown to make a scheduled meeting date may send definitive proxy materials 10 days after filing of the preliminary

statement, as the Staff will not review any proxy statements during the shutdown.

PROXY ADVISORY FIRM UPDATES

ISS Updates

Institutional Shareholder Services (ISS) updated its Proxy Voting Guidelines Updates for 2019 to include several changes and modifications, a summary of which is outlined below.

Board Composition – Diversity: For companies in the Russell 3000 or S&P 1500 indices, effective for meetings on or after February 1, 2020, ISS recommends to generally vote against or withhold from the chair of the nominating committee (or other directors on a case-by-case basis) at companies when there are no women on the company's board, though mitigating factors include: (i) a firm commitment, as stated in the proxy statement, to appoint at least one female to the board in the near term; (ii) the presence of a female on the board at the prior annual meeting; or (iii) other relevant factors as applicable.

Board Accountability – Management Proposals to Ratify Existing Charter or Bylaw Provisions: Though ISS did not have a policy previously, ISS now recommends voting against or withholding from individual directors, members of the governance committee, or the full board, when boards ask shareholders to ratify existing charter or bylaw provisions. The rationale for this change is in response to an increase of board sponsored proposals.

U.S. Employee Plan Scorecard (EPSC): ISS announced that although passing scores for all EPSC models will remain the same as in effect for 2018, change in control (CIC) vesting factors will be updated to provide points based on the quality of disclosure of CIC vesting provisions. Additionally, ISS stated a new negative factor will be triggered when a company's equity compensation program is estimated to dilute shareholder holdings by more than 20 percent for the S&P 500 model or 25 percent for the Russell 3000 model.

Shareholder Proposals on ESG Issues: This update by ISS was made to codify the factors already being taken into consideration in ISS's case-by-case analyses of ESG shareholder proposals and to make it more explicit that significant ramifications are considered when evaluating ESG shareholder proposals. ISS also directed its attention to the board's oversight of ESG issues.

In its publication, ISS also addresses: (i) economic value added data for pay-for-performance evaluation (for informational purposes only), (ii) board responsiveness, (iii) virtual-only shareholder meetings, (iv) conflicting management and shareholder special meeting proposals, and (v) excessive non-employee director compensation.

A copy of the full ISS 2019 Proxy Voting Guidelines Updates is available here.

Glass Lewis Updates

Glass, Lewis & Co. (Glass Lewis) also recently published its 2019 Proxy Paper Guidelines, which include several changes and modifications, a summary of which is outlined below.

Board Gender Diversity: Glass Lewis's policy regarding board gender diversity, announced in November 2017, will take effect for meetings held after January 1, 2019. For 2019 meetings, Glass Lewis will generally recommend voting against the nominating committee chair of a board that has no

female members. However, when making these recommendations, Glass Lewis will carefully review a company's disclosure and/or sufficient rationale and may refrain from recommending shareholders vote against directors of companies outside the Russell 3000 index.

Conflicting and Excluded Proposals: Glass Lewis has now codified its policy regarding conflicting special meeting shareholder resolutions. In addition, Glass Lewis will begin noting instances where the SEC has allowed the exclusion of a company's shareholder proposals.

Environmental and Social Risk Oversight: Similar to the exclusion of shareholder proposals, Glass Lewis has codified its approach to reviewing how boards are overseeing ESG issues. For instance, where material oversight issues have been identified, Glass Lewis will review a company's overall governance practices and identify which directors or committees have been charged with such oversight, noting when such oversight has not been clearly prescribed. Glass Lewis further clarified it may consider recommending shareholders vote against members of the audit committee in instances of mismanagement or failure to appropriately mitigate.

Executive Compensation: Glass Lewis has clarified that when evaluating contractual payments and arrangements, such as severance and sign-on arrangements, it will consider general U.S. market factors and the size and design of entitlements as possible contributing factors to a negative voting recommendation on say-on-pay. ISS has also indicated that a "good reason" trigger in a change in control severance arrangement should be limited to circumstances that are reasonably viewed as adverse constructive terminations.

In its update, Glass Lewis also made clarifying amendments to its (i) auditor ratification proposals at business development companies, (ii) director recommendations on the basis of company performance, (iii) director and officer indemnification, (iv) NOL protective amendments, (v) OTC-listed companies, and (vi) quorum requirements, along with several minor housekeeping edits, including removal of outdated references to enhance clarity and readability.

A copy of the full Glass Lewis 2019 Proxy Paper Guidelines is available here.

OTHER SECURITIES LAW DEVELOPMENTS

Best Practices for Being Virtual-Only

With virtual-only shareholder meetings on the steady rise with no indication of slowing down, a committee of executives representing a multitude of constituents issued in April 2018, "Principles and Best Practices For Virtual Annual Shareowner Meetings." They outlined at least five guiding principles for virtual shareholder meetings and articulated 12 best practices. Some of the best practices identified specifically related to technical access and support, as well as the ability to discuss annual meeting format.

Disclosure Update and Simplification

On August 17, 2018, the SEC amended certain of its disclosure requirements to simplify and streamline the disclosure process. According to the release, the amendments were "intended to facilitate the disclosure of information to investors and simplify compliance without significantly altering the total mix of information provided to investors." Companies should be aware of the movement of some disclosure items to the financial statements, and vice versa, impacts on audit reviews, XBRL tagging requirements, and the ability to rely on the forward-looking safe harbor under

the Private Securities Litigation Reform Act of 1995.

Impact on Disclosures by the Tax Act

Accounting Impact of Tax Reform SEC Staff Accounting Bulletin No. 118 (SAB 118) provides guidance on the necessary disclosures related to the accounting impact of the Tax Act, including providing a three-part procedure for companies to follow when accounting for and reporting the income tax effects of the Tax Act in financial statements that include a reporting period. Companies should continue to refer to SAB 118 when preparing financial statements for their annual reports for the 2019 proxy season.

Changes to Form 10-K Cover Page

There are two technical changes to the cover page of annual reports on Form 10-K this year. The first change eliminates the instruction informing filers to not check the “non-accelerated filer” box if the issuer is an SRC. The second change relates to the SEC’s adoption of the inline XBRL format for the submission of operating company financial statement information. Basically, the SEC has already implemented changes to the Form 10-K cover page to reflect the Inline XBRL amendments eliminate the need for operating companies to file separate exhibits or post an interactive data file on their websites, even though the new format does not apply to upcoming annual reports on Form 10-K for calendar year 2018.

TAKEAWAYS

In the past calendar year we saw an increase in midterm voter turnout—a 50-year record high—and though we did not quite see that big of a jump in shareholder votes, there were certainly some shareholder activism trends and developments to take note of, including the substantial increase in the number of exempt solicitation filings made by institutional and retail investors alike. In fact, these filings for 2018 were up 43 percent compared to 2016. We also saw an increase in the visibility of “vote no” or “withhold” campaigns. Upon review, while the voting numbers remained stable, the number of topics shareholders deem important has grown. What this seems to mean is though shareholder voting has not reached that level of voter turnout we saw in the midterms—perhaps because shareholders have not been faced with such an incident to spur that turnout—shareholders are continuing to use their votes in a meaningful, powerful way, and it appears we are only just beginning to see the effects this will inevitably have on proxy advisory firms and the SEC. This is exemplified by statements from SEC Chair Jay Clayton and the fact that the SEC held a roundtable in November 2018 about proxy process, focusing on the role of proxy advisory firms, the importance of which was underscored by the introduction of the Corporate Governance Fairness Act (an act that was implemented and designed in order to “help ensure that investors may confidently rely on the advice of proxy advisory firms by requiring all the [SEC] to regulate all major proxy advisory firms under the Investment Advisers Act . . .”). The SEC’s roundtable also covered proxy voting mechanics and technology and shareholder proposals. The Proxy Roundtable Transcript can be accessed here.

To prepare for the 2019 proxy season, companies should review the new rules and trends and take inventory of their base, policies, and procedures. Preparing for this season is still as much about hedging risk as it is about strategically planning for the future. However, as we move into 2019, it will likely prove useful to reassess (and to benchmark) proxy disclosures in the key areas of interest to shareholders and promote engagement with company shareholders. Remember, what companies do on their off season is as important as what they do during their proxy season.

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