Published on *The National Law Review* https://natlawreview.com

A Proxy Season Guide to 2020

Article By:

David J. Lavan

The 2019 proxy season marked a year of continued changing voting behavior. Though patterns and trends of the past season do not seem to indicate changes beyond marginal impact, the 2019 season can serve to set expectations for the 2020 proxy season. From new overboarding policies to general scrutiny of shareholder proposals to new securities laws updates and business developments, public companies must ensure they are up to date in an era when proxy statements are often used as the major communication mechanism to their shareholders and the public. The following is a review of the 2019 proxy season, along with a summary of new and anticipated changes that may impact reporting and disclosure requirements for the 2020 proxy season.

2019 IN REVIEW

Each proxy season results in a handful of changes – some are significant but most are minor. Though environmental, social, and governance (ESG) disclosures, as well as sustainable investing, have been trending in Europe for the past 20 years, these concepts only began gaining traction in the United States a few years ago. The 2019 proxy season continued down the same path as the 2017 and 2018 proxy seasons in regard to the focus and attention devoted to ESG topics. Despite their numerosity, environmental and social (E&S) proposals still garnered little shareholder support – averaging 28 percent in 2019, up one point from 2018. However, more ESG proposals went to a vote in 2019 than in previous years – nearly half of submitted ESG proposals went to a vote last year, while in 2018 only about one-third reached that stage, that increase seemingly signifies investor dissatisfaction regarding company response to ESG issues. Indeed, only 30 percent of investors find ESG information provided by companies sufficient in helping them assess materiality to a company's business. Proposal topics that secured majority support included, among others, sustainability reporting and climate change, policies regarding the reporting on sexual harassment, board diversity, political spending, and the opioid risk.

Despite the angst surrounding ESG topics, 2019 saw little change in average rates of shareholder support – down two points from 2018 to 2019, along with the lowest volume of shareholder proposals in the past five years. However, investor concern continued to place greater importance on a wider range of topics, including the aforementioned ESG issues, proposals on say-on-pay, accountability of boards of director elections, executive compensation, independent board chairs, and board diversity. Opposition votes on say-on-pay proposals increased in 2019, with around 14 percent of such proposals receiving less than 80 percent support, levels which have not been seen since immediately after the financial crisis. In 2019, the emphasis placed on board diversity resulted in the highest proportion of newly added female directors on record. Overall, for the third consecutive year, environmental and social proposals outnumbered governance proposals, as the breadth of governance topics addressed by shareholders is narrowing, and the range of E&S issues continues to expand to encompass topics such as climate change, as well as the increase of political spending resolutions in advance of the 2020 presidential election.

Institutional investors continued to focus their attention and efforts on board composition, long-term performance and sustainability, and environmental and social issues. The focus on board composition included topics such as supermajority voting provisions, but the big shift has been toward diversification, as well as opposition by institutional investors to director "*overboarding*" – the idea that directors should not serve in that capacity for too many public companies. Institutional investors continued to tighten their overboarding policies, or adopted new policies to deter overboarding, as they argue overboarded directors lack sufficient time to dedicate to their roles and is an impediment to a director's ability to focus on each board's requirements. Generally, institutional investors allow a board member to sit on anywhere between two and six boards. These policies deviate from Institutional Shareholder Services (ISS) and Glass Lewis, & Co. (Glass Lewis), and the number of board seats permitted by a certain director is generally dependent on whether the director is an independent director, the CEO, or a named executive officer.

Though each year, and each proxy season, brings some level of change, the 2019 season brought a significant divide in the voting trends between institutional and retail investors, demonstrating the importance of companies engaging with all shareholders, especially given the fact retail shareholders were less supportive of shareholder proposals than institutional investors but more supportive of directors who failed to receive majority support. Despite this divide, both institutional and retail investors continued the focus and pressure on companies regarding diversity issues, such as gender pay gaps and diversification of boards. Given the interest in such topics, this theme is likely to intensify this year in light of the upcoming 2020 presidential election.

2020 IN PROCESS

The 2020 proxy season will see a first – compliance with new hedging disclosure requirements, along with other several key developments, all of which are important when preparing company proxies and annual reports.

Dodd-Frank Hedging Disclosure Rule

The SEC adopted a rule at the end of December 2018 requiring companies to disclose their hedging policies and practices for employees, officers, and directors. The 2020 proxy season will be the first proxy season in which most public companies will need to include the new hedging disclosure in their proxy statements, while a majority of smaller reporting companies (SRCs) and emerging growth companies (EGCs) will not have to comply until 2021. The requirements also apply to all companies required to comply with the proxy rules. The new rule requires companies to disclose whether employees, including officers, or directors are permitted to purchase financial instruments or otherwise engage in transactions that hedge or offset, or are designed to hedge or offset, any decrease in the market value of a company's equity securities granted to the employee or director as compensation or held directly or indirectly by the employee or director. Notably, the rule only requires the disclosure of practices and policies, not of past hedging transactions that have occurred. Companies can satisfy this new disclosure requirement by either:

- providing a fair and accurate summary of the practices or policies, either written and unwritten; or
- disclosing the practices and policies in full.

The disclosure must state the category of employees covered by the policy and/or procedures, and if a company does not have any policies or practices regarding hedging, it must disclose that fact and whether hedging transactions are permitted.

The hedging disclosure requirement extends beyond the pre-existing requirement that the compensation discussion and analysis (CD&A) address hedging policies affecting the executive officers, whose compensation is required to be disclosed in an annual meeting proxy statement to the extent material to a discussion of their compensation. The new requirement mandates disclosure of hedging policies with respect to all employees, officers, and directors, whether or not material to their compensation.

The new disclosure requirement is another of the SEC's "*name or shame*" rules not requiring the adoption of anti-hedging policies but requiring a company that does not have an anti-hedging policy to so state or to state that hedging transactions generally are permitted. Further in this regard, note both ISS and Glass Lewis, in addition to certain influential institutional investors, are supportive of executive anti-hedging policies.

Critical Audit Matters (CAMs)

Previously-approved standards approved by the SEC in 2017 are beginning to be required in auditor reports filed on EDGAR regarding disclosure of CAMs. A CAM is defined as any matter arising from an audit communicated or required to be communicated to the audit committee, and:

(1) relates to accounts or disclosures material to the financial statements, and

(2) involves especially challenging, subjective, or complex auditor judgment.

The CAM disclosure rules apply to auditor reports related to:

(1) fiscal years ending on or after June 30, 2019 for large accelerated filers, and

(2) fiscal years ending on or after Dec. 15, 2020 for all other companies required to file auditor reports. Once the CAM disclosures apply to a company, all auditor reports are required to include disclosure of any CAMs or alternatively a statement from the auditor that no CAMs exist for the period under audit.

To reduce the potential for surprise and think through possible disclosure issues, we encourage companies to engage their auditors early about their process for identifying potential CAMs. Further, early notice from the auditor about potential CAMs will enable companies to determine whether anticipated CAM disclosure in the audit report should drive additional disclosure in their Form 10-K, including management's discussion and analysis and the notes to the financial statements.

Pay Ratio Disclosure

The 2020 proxy season marks the third year of mandatory pay ratio disclosures in proxy statements. The rule requires companies to disclose, as a ratio, a comparison of the annual total compensation of the chief executive officer (CEO) and its “median” employee. Companies are only required to identify its median employee once every three years provided they reasonably believe there has been no change in their employee population or compensation arrangements. Companies should determine whether any such change is necessary, specifically if they recently closed a significant acquisition that could affect workforce composition or compensation arrangements.

A review of the last two proxy seasons suggests while the pay ratio disclosure has not necessarily impacted employee compensation, the disclosures can provide newspaper headlines that affect employee morale, customer choices, and potentially legislation targeting executive pay. For example, San Francisco voters will vote this November on a “CEO pay tax,” while Washington and five other states are considering similar measures. Such bills look to add a surcharge to a local business tax for companies when the CEO makes at least 100 times as much as a median employee.

Board Diversity: Compliance and Disclosure Interpretations (C&DIs)

In February 2019, the SEC’s Division of Corporation Finance released two C&DIs related to the disclosure self-identified diversity characteristics of board members and board nominees. The guidance indicates, should a company’s nominating committee consider diversity characteristics such as gender, race, disability, and other self-identified characteristics, the disclosure should also include a description of those characteristics and how they were considered, as well as how the company considers other qualifications its diversity policy encompasses, such as military service or socio-economic background.

This push for diversity on boards has led to concrete change. The Wall Street Journal reported as of summer 2019, there were no longer any S&P 500 companies with all-male boards, and ISS reported there is a record number of members of ethnic minorities becoming directors, though the rate of this change is slower than the rate of change in gender diversity. The push for diversity can also be seen in Congress. On the same day the SEC’s Division of Corporation Finance released the aforementioned C&DIs, the “Improving Corporate Governance Through Diversity Act of 2019” was introduced in both houses of Congress. The bill seeks to require public companies to disclose in their proxy statements data regarding the gender, race, ethnicity, and veteran status of their directors and nominees, as well as senior executive officers. The bill was passed in the U.S. House of Representatives on Dec. 12, 2019 and will go before the Senate in 2020.

SEC Issues Interpretative Guidance on Shareholder Proposal No-Action Request Procedure Changes

In September 2019, SEC staff released a memorandum announcing two significant procedural changes to the Rule 14a-8 no-action letter process. First, the memorandum sets forth the discretion of the staff in responding to no-action requests, in that, beginning with the 2019-2020 shareholder proposal season, the staff may respond orally rather than in writing when it does not believe a written response would provide value. Second, the staff may now more frequently decline to state a view with respect to the company’s asserted basis for exclusion. Discussed further within this article, Glass Lewis announced it will likely recommend against governance committee members for a company that excludes a shareholder proposal for which the staff declined to take a view.

Division of Corporation Finance Issues Additional Proposal Guidance

On Oct. 16, 2019, the Division of Corporation Finance published additional guidance for companies submitting no-action requests to exclude shareholder proposals from proxy statements. The staff advised companies of the following:

- They should abstain from an overly-technical reading of proof of ownership letters, especially in the form of documentary support;
- When considering exclusion arguments based on micromanagement, the company inquiry should look to whether the proposal imposes a specific strategy, method, action, outcome, or timeline;
- Whether a proposal relates to a "significant party issue" in the context of the "ordinary business" exception under Rule 14a-8(i)(7) is a fact-intensive inquiry for a particular company and there are no issues or categories of issues universally "significant"; and
- When determining whether a no-action request concerning a proposal the company's board believes is not significant, the company should identify the differences between the way in which the company addressed the issue, the manner in which the proposal seeks to address the address the issue, and to explain why those differences do not represent a significant policy issue to the company. By way of example, the staff stated that a helpful analysis could include how the company's subsequent actions of shareholder engagement on the issue bear on the significance of the underlying issue to the company.

Finally, given the SEC's recent focus on accurate reporting of perquisites (or perks), as evidenced by the recent increase in SEC enforcement actions related to perk disclosures, companies should pay particular attention to perk disclosures. To ensure accurate disclosure of perks in 2020 statements, companies should review the SEC's "integrally and directly related" standard for reporting perks, especially those tasked with preparation of CD&As.

PROXY ADVISORY FIRM UPDATES

ISS Updates

Institutional Shareholder Services (ISS) updated its Proxy Voting Guidelines Updates for 2020 to include several changes and modifications, a summary of which is outlined here for companies to consider as they draft their proxy statements and prepare for annual meetings.

Board of Directors – Voting on Director Nominees in Uncontested Elections: ISS clarified a "new nominee" could include a director who had been appointed by the board to fill a vacancy and thus had technically already served on the board. ISS also clarified only new nominees who have served for less than a year *may* be excused from responsibility for problematic governance issues, meaning ISS will consider them on a case-by-case basis.

Board of Directors – Board Gender Diversity: ISS, as well as most institutional investors, remain focused on board gender diversity. ISS will recommend against nominating committee chairs at Russell 3000 and S&P 1500 companies when there are no women directors, absent certain mitigating factors. A company with an all-male board may qualify for a mitigating factor if it shows a firm commitment to appoint one woman director within a year. Companies should note this mitigating factor will only be around through 2020.

Board Accountability – Problematic Governance Structure – Newly Public Companies: ISS provided a specific and updated list of bylaw or charter provisions it believes to be materially adverse to shareholders, including, without limitation, provisions such as supermajority vote requirements to amend the bylaws or charter, a classified board structure, and other “egregious provisions.” A reasonable sunset to these provisions would be a mitigating factor.

Independent Board Chair – Shareholder Proposals: ISS updated its list of factors to take into account when recommending a vote for shareholder proposals requiring the chair of the board be independent. Most notably, ISS will not take into consideration the “rationale” for the shareholder proposal. In addition, ISS added the following, non-exhaustive, specific factors that will increase the likelihood of a recommendation to vote for an independent chair shareholder proposal: a weak or poorly defined lead independent director role that fails to serve as an appropriate counterbalance to a combine CEO/chair role; the presence of an executive or non-independent chair in addition to the CEO; a “material governance failure”; and evidence the board has failed to intervene when management’s interests are contrary to shareholders’ interests.

In its publication, ISS also addresses: (i) Exemptions for new nominees, (ii) Board Composition – Attendance, (iii) Board Accountability – Restrictions on Shareholders’ Rights, (iv) Share Repurchase Programs, (v) Equity-Based and Other Incentive Plans – Evergreen Provision, and (vi) Diversity – Gender Pay Gap.

A copy of the full ISS 2020 Proxy Voting Guidelines Updates, in the form of an executive summary, is available here.

Glass Lewis Updates

Glass, Lewis & Co. (Glass Lewis) recently published its 2020 Proxy Paper Guidelines, which include several changes and modifications, a summary of which follows.

Governance Structure and the Shareholder Franchise – Exclusive Forum: Glass Lewis clarified its policy to make exceptions when the exclusive forum provision is narrowly crafted to suit the company’s unique circumstances or if it includes a reasonable sunset provision. This updates their policy, which previously recommended voting against the governance committee chair when a company has adopted an exclusive forum provision without shareholder approval.

Nominating and Governance Committee – Excluded Shareholder Proposals: Glass Lewis adopted a new policy where it will generally recommend voting against all members of the governance committee when the SEC staff declines to state a view on a company’s no-action request and when the company excludes the shareholder proposal from its proxy materials. When the SEC staff orally responds to a company’s no-action request, Glass Lewis expects the company to provide some disclosure concerning the no-action relief in its proxy statement. When the company chooses to exclude a proposal from its proxy materials without such disclosure, it will generally recommend against all members of the governance committee.

Election of Directors – Compensation Committee Performance: Glass Lewis codified additional factors it will consider when evaluating the performance of compensation committee members, including recommending against all members of the compensation committee when the board adopts a frequency for its advisory vote on executive compensation other than the frequency approved by a plurality of shareholders.

In its update, Glass Lewis also made clarifying amendments to its:

(i) Board Attendance policy,

(ii) Company Responsiveness to Low Say-on-Pay Vote,

(iii) Say-on-Pay Frequency,

(iv) Supermajority Voting Shareholder Proposals,

(v) Gender Pay Equity Shareholder Proposals, and

(vi) Contractual Payments and Arrangements, along with several minor housekeeping edits, including the removal of several outdated references, to enhance clarity and readability.

A copy of the full Glass Lewis 2020 Proxy Paper Guidelines is available here.

OTHER SECURITIES LAW DEVELOPMENTS

New Disclosure Simplification Rules Adopted

Effective May 2, 2019, in an attempt at modernization and simplification, the SEC adopted amendments streamlining certain disclosure requirements of Regulation S-K. Companies that have not filed annual reports on Form 10-K since the effective date of the amendments will be applying them for the first time this season. Key changes include the following:

- MD&A instructions have been revised to provide that a registrant may use any presentation that, in its judgment, enhances a readers understanding of the registrant’s financial condition, changes in financial condition, and results of operations. Amendments to 303(a) instructions eliminate the need to discuss the earliest year in certain circumstances if financial statements included in a filing cover three years;

- The SEC eliminated specific examples of risk factors from Regulation S-K to encourage registrants to focus on their own risk identification process;

- Form 10-K Cover Page should no longer include any reference to delinquent Section 16 filings, and the cover page data should be tagged in Inline XBRL; and

- Form 10-K Exhibits must now include a new exhibit, required by Item 601(b)(4)(vi) or Regulation S-K, that includes a description required by Item 202(a) through (d) and (f) or Regulation S-K for each class of securities registered under Section 12 of the Exchange Act.

SEC Proxy Advisory Firm Guidance

In August 2019, the SEC released guidance, aimed at proxy advisory firms, to assist investment advisers in fulfilling their proxy voting responsibilities. The guidance provides matters investment advisers should consider when using services of proxy advisory firms. In particular, the SEC issued an interpretation that proxy voting advice provided by firms like ISS and Glass Lewis constitutes a “solicitation” under federal proxy rules, meaning these firms would be tasked to do more to ensure the advisers are fulfilling their fiduciary duties. The SEC then proposed a rule on Nov. 5, 2019 that could fundamentally change the way proxy advisory firms operate: the rule proposes proxy advisory firms provide companies with their reports in advance and give them a forum for review and feedback, ultimately creating comprehensive conflicts of interest disclosures. This rule would not go into effect in 2020; however, given the fact that ISS is currently challenging the guidance in court, the guidance and subsequent court ruling of the proposal will likely influence the dynamic this year.

ESG Disclosures

China's compulsory ESG disclosure requirements kick in this year for all listed entities. In the United States, though not mandatory, many companies are facing growing pressure from investors to provide additional disclosure of ESG topics. Given BlackRock CEO Larry Fink's annual letter discussing a "modern standard for corporate responsibility," and thus an emphasis on commitment to all stakeholders as discussed above, ESG disclosures will likely continue to see an increase in 2020, and companies should be prepared for investor "ESG screens" to impact voting and investment decisions. Given the progress and extent of voluntary ESG reporting by companies here in the United States, we likely will not see any regulatory requirements in 2020 mandating ESG disclosures similar to those in China.

TAKEAWAYS

As the consensus regarding the economic impact of climate change begins to coalesce, along with a consensus by stakeholders for companies to operate in a manner that demonstrates a commitment to a wider audience, we will likely continue to see the trends of collective actions by investors on the importance of addressing climate risk and pay for performance, leading to an increase is ESG proposals through investor coalitions. The increase in proposals will likely occur so long as the proposals do not become too specific that they are deemed to micromanage a company by prescribing the method for addressing a certain issue, such as greenhouse gas emissions. In terms of governance, more companies will likely adopt or expand public disclosure on human capital management given the growing pressure from investors and regulators, particularly given the SEC's Investment Advisory Committee's vote to recommend the SEC consider imposing a requirement for public companies to make disclosures relating to human capital management disclosure.

There was also an increase in the first half of the year of the amount of investors creating sustainability data systems to aid in investment purposes. The systems are created around sustainability ratings and are intended to evaluate and incorporate environmental and social factors throughout the investment cycle to strategically leverage ESG data in aiding investors in investment decision-making. This is an attempt to address the lack of consistency in companies' ESG reports and disclosures and the resulting inability of companies to properly benchmark against their peers. In fact, while nearly all S&P 500 companies provided some form of ESG or sustainability reports in 2019, there is still concern by stakeholders regarding the quality, comparability, and usefulness of these reports. These sustainability data systems will continue to aid investors throughout the 2020 proxy season and could lead to an increase in stakeholder demands for more transparent and higher quality ESG reporting.

The 2020 proxy season will also likely continue to bring complexity as investors continue digging further into compensation plans. Further, while data privacy and cybersecurity were not on the forefront in the proxy advisory firm updates or SEC guidance, new data privacy laws such as the General Data Protection Regulation in the European Union may spur shareholders to submit more proposals of this type going forward, particularly if investors believe disclosures made by companies on issues relating to cybersecurity and/or data privacy are outdated, overly generalized, or otherwise lacking. As we saw with two of Amazon's proposals in 2019, one potential subject of these anticipated proposals might focus on facial recognition, particularly regarding fraud prevention and security.

To prepare for the 2020 proxy season, companies should review the new rules and trends and take inventory of their base, policies, and procedures. It will likely prove useful to reassess proxy disclosures in the key areas of interest to shareholders and promote engagement with company shareholders. Remember, what companies do in their proxy off-season is as important as what they do during their proxy season.

National Law Review, Volume X, Number 7