Cooley

Comp Talks Proxy Season Rundown – Scrutinizing 2018 to Improve 2019

Reid Pearson, Alliance Advisors

Megan Arthur Schilling, Cooley

***Moderated by* Amy Wood, Cooley**

Need immediate technical assistance?

Krista Florea

720-566-4063

kflorea@cooley.com

What Are We Talking About?


2018

Larry Fink Opened 2018 Proxy Season with “A Sense of Purpose”

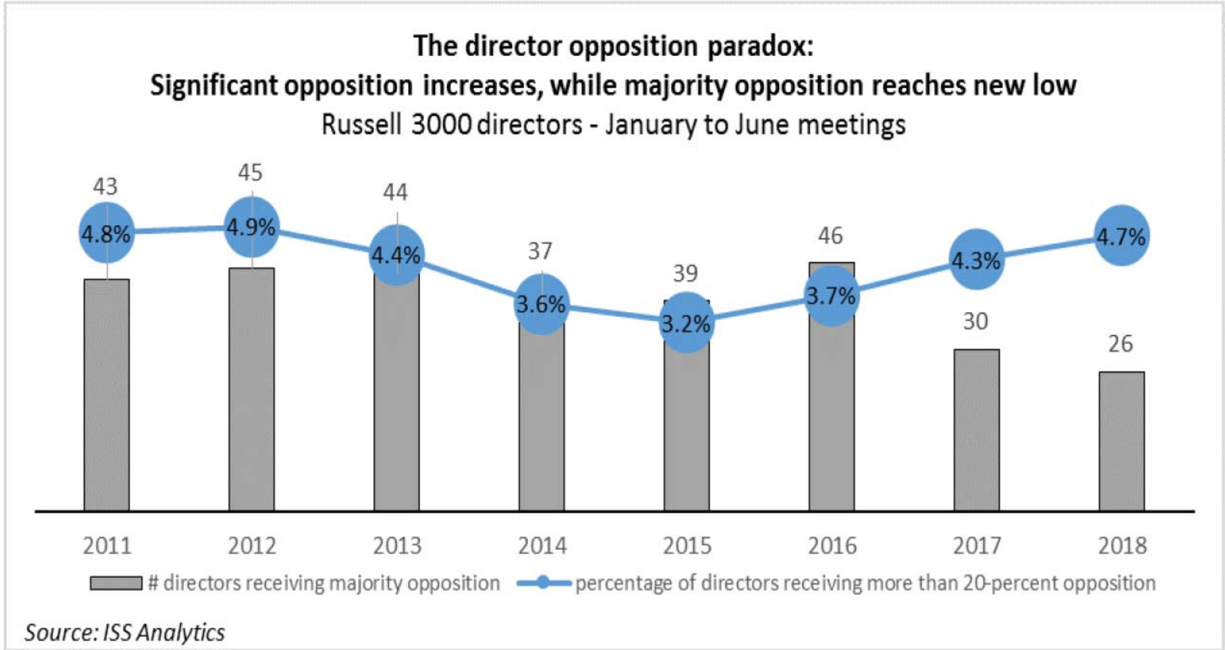
“Companies must ask themselves: What role do we play in the community? How are we managing our impact on the environment? Are we working to create a diverse workforce? Are we adapting to technological change? Are we providing the retraining and opportunities that our employees and our business will need to adjust to an increasingly automated world? Are we using behavioral finance and other tools to prepare workers for retirement, so that they invest in a way that will help them achieve their goals?”



Director Elections

- **96% average shareholder support** for directors; less than 1% failed to receive majority support
  - Directors with positive ISS recommendations received 97% average support vs. directors with negative ISS recommendations received 82% average support

- Shareholders expressed more concern against directors → **increased levels of "significant" opposition**
- Lack of responsiveness to compensation matters/say on pay was correlated with *lowest levels of support* for directors



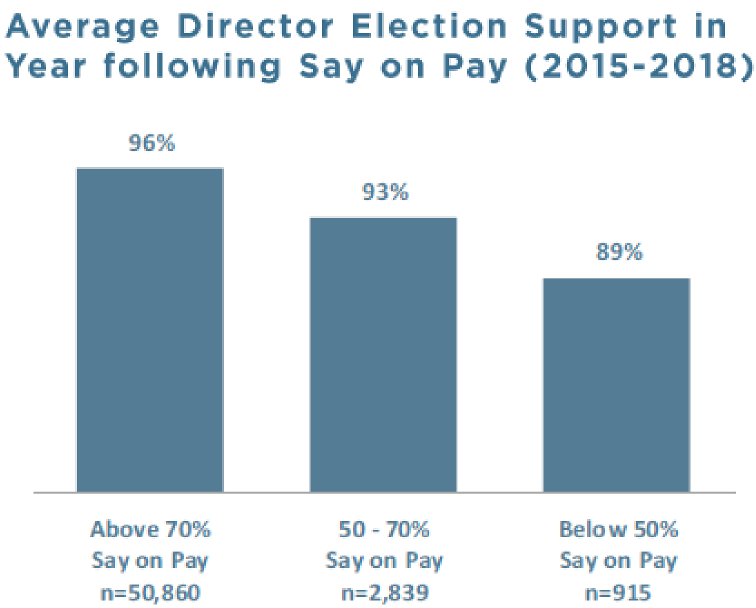
Director Elections

Most common reasons for ISS negative recommendations against directors:

1. Independence issues
2. Newly public companies with adverse governance provisions
3. Absence of formal nominating committees
4. Shareholders not permitted to amend bylaws (N/A for DE corps)
5. Poor attendance
6. ***Compensation issues***
7. Poison pill issues
8. Overboarding
9. ***Lack of responsiveness to shareholder concerns***
10. Pledging of shares by executives or directors
11. Failure to address material weakness in internal controls
12. Unilateral action that reduces shareholder rights

Issues correlated with the *lowest levels* of support for directors:

1. Lack of responsiveness (including re compensation issues)
2. Compensation issues

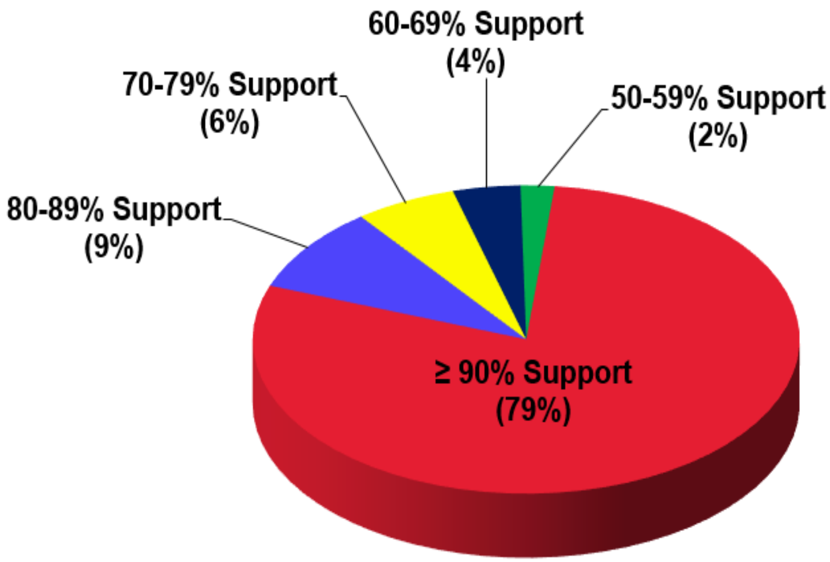


Graphic from Semler Brossy

Say-on-Pay

- Another year of **strong** say-on-pay results
- **98% of all proposals passed** (compared to 83% following negative ISS recommendation)
- **Average support at 91%** (slightly down from 2017), median support fell to new low (below 96%)
- 2% failure rate (2x the failure rate in 2017)
- Proposals receiving lower levels of support trigger heightened scrutiny in following year
- ***Remember: a successful vote does not guarantee success in the following year***

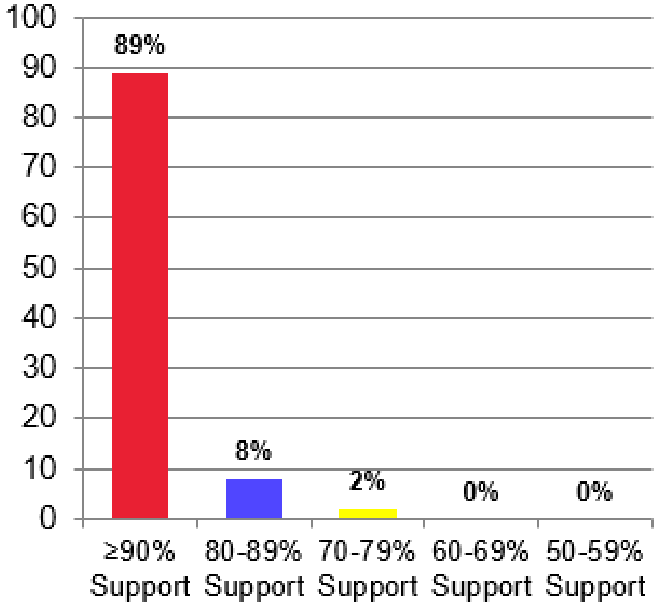
Results of 2018 Passed Proposals



Results of 2018 Passed Say-on-Pay Proposals Following...

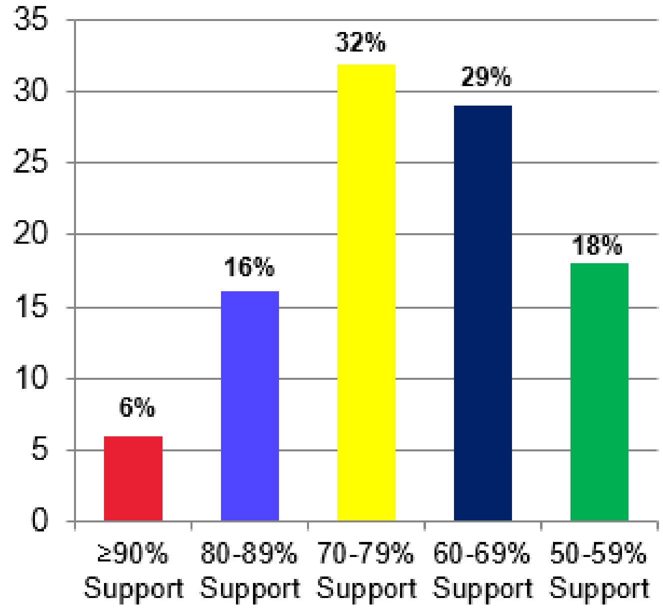
Positive ISS Recommendation

95% average support*



Negative ISS Recommendation

71% average support*



* Percentages do not add to 100% due to rounding

Data from ISS Voting Analytics database as of July 31, 2018

Say-on-Pay

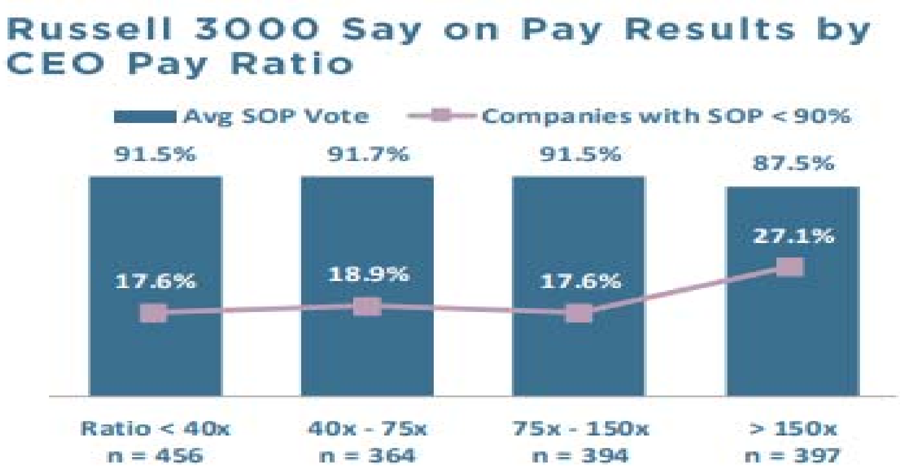
- Most common reasons for lower levels of support:
  - Pay for performance disconnect (dominant reason is relative alignment of CEO pay and TSR)
  - Other common reasons: compensation committee responsiveness, “problematic pay practice” (e.g., severance/CIC practices, peer group benchmarking, lack of performance-based pay, “one off”/mega awards)
- ISS quantitative pay-for-performance screen has significant impact on ISS vote recommendations (51% of companies with “high” concern received “against” recommendations)
- Trends: more shareholder (and proxy advisory firm) engagement, better disclosure, better understanding of issues

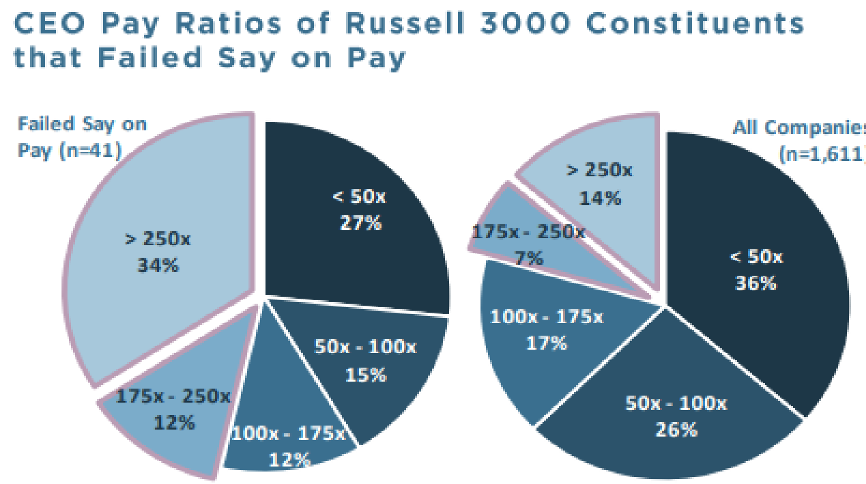
Say on Pay – Advice for 2019

- Pay close attention to levels of shareholder support
- Formulate a plan if shareholder support levels are "low" (<70% ISS, <80% Glass Lewis)
- Understand/monitor the ISS and Glass Lewis pay-for-performance screens (including the financial performance assessment)
- Monitor your shareholder base and shareholder preferences
- A successful vote does not guarantee success in the following year
- Consider certain disclosure enhancements and start early
- Engage!

Pay Ratio

- Pay ratio was first effective for the 2018 proxy season
- Pay ratios did not drive say-on-pay votes; no backlash from proxy firms or institutional investors, but future scrutiny is very possible (e.g., year-over-year changes, industry comparisons)
- Some (but less than expected) reactions from employees





Data from the Semler Brossy 2018 Say on Pay and Proxy Results Russell 3000 dated July 12, 2018

Pay Ratio – Advice for 2019

- May use same "median employee" as identified for purposes of 2018 disclosure, as long as:
  - no change in ***employee population*** or ***employee compensation*** arrangements that company ***reasonably believes*** would result in ***significant change*** to pay ratio
  - Must include employees from any acquired business excluded from employee population in prior year to determine if "significant change" has occurred
- If use same "median employee," must disclose this fact and basis for reasonable belief that there were no changes to employee population or compensation arrangements that would significantly impact ratio
- If the original median employee's circumstances changed in a way that would result in a significant change in pay ratio, may use another employee whose compensation is substantially similar to the original median employee

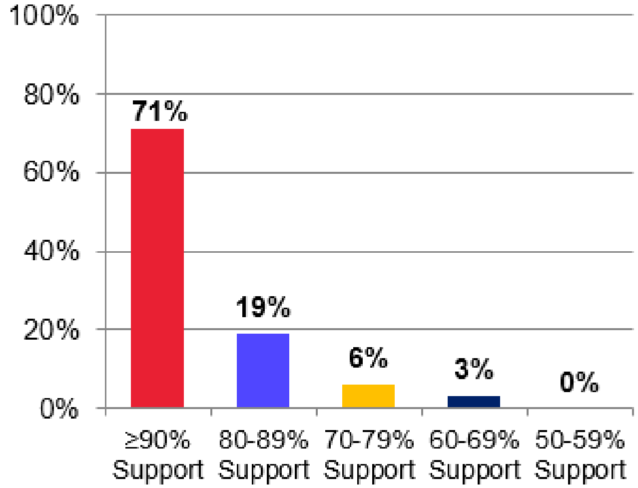
Pay Ratio – Advice for 2019

- Other potential new disclosure matters:
  - Change in "determination date" – must disclose change and provide "brief explanation" about the reason(s) for change
  - Change in methodology or material assumptions, adjustments, or estimates from those used in its disclosure for prior fiscal year, and if effects of any such changes are significant, must briefly describe change and reason(s) for change
  - Cost-of-living adjustment (COLA) – must disclose if change from using a COLA to not using a COLA and if changed from not using a COLA to using a COLA

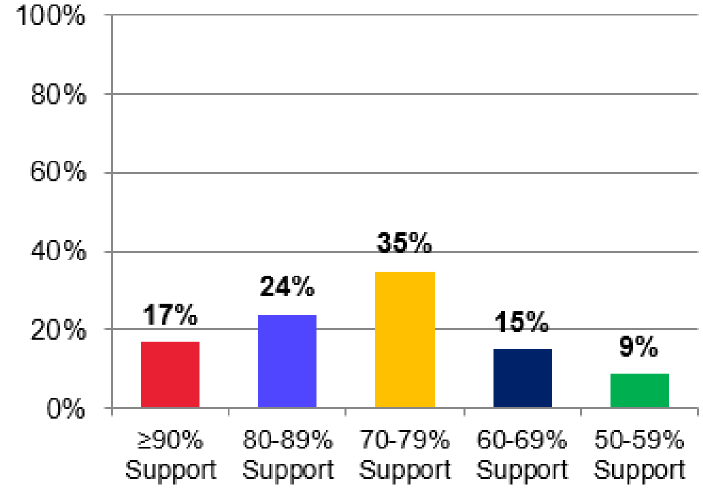
Equity Plan Proposals

- **Broad support:** ~99% proposals pass, average 89% support (*but: 99% of all statistics only tell 49% of the story!*)
- **Results of 2018 Passed Equity Plan Proposals Following….**

Positive ISS Recommendation
91% average support



Negative ISS Recommendation
78% average support



Data from ISS Voting Analytics database as of July 31, 2018

Equity Plan Proposals – Advice for 2019

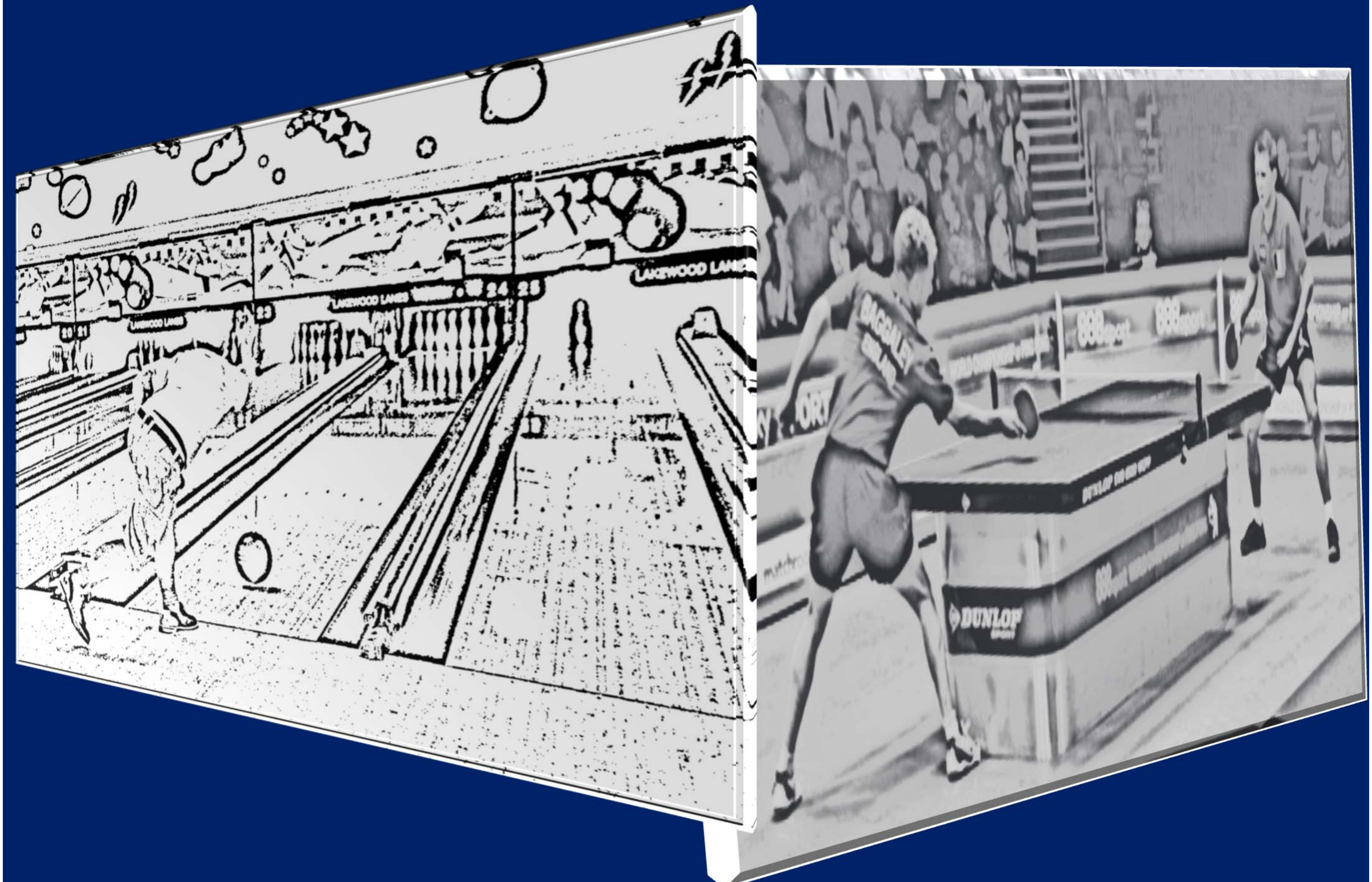
- Most proposals are based on serious homework and designed to pass – *don't be fooled by statistics*!
- Invest the resources necessary to design a proposal that will pass
- Consider enhanced proxy disclosure
- Ensure proposal contains correct proxy tables
- Consider director compensation limits and 162(m) implications

Engagement: What Do Institutional Investors Expect and Why?

What Did We See in 2018?

- Steady climb over the past six years of increase in shareholder engagement and proxy disclosure of that engagement (especially on compensation-related topics)
- No longer just a focus for S&P 500 companies; small-cap and recently public companies are engaging too
- Engagement continued to be more *proactive* than reactive and more *entrenched in corporate culture*
- Compensation continues to be a key topic
- Dialogues influence changes in disclosure and practices, particularly compensation changes
- Increased focus on responsiveness

What Should It Look Like?



Institutional Investors – In Their Own Words

BlackRock – a new model for corporate governance

"The time has come for a new model of shareholder engagement – one that strengthens and deepens communication between shareholders and the companies that they own. I have written before that companies have been too focused on quarterly results; similarly, shareholder engagement has been too focused on annual meetings and proxy votes. If engagement is to be meaningful and productive – if we collectively are going to focus on benefitting shareholders instead of wasting time and money in proxy fights – then engagement needs to be a year-round conversation about improving long-term value."

– Lark Fink's 2018 annual letter to CEOs

Vanguard – the full arc of engagement

"Engagement has improved substantially over the last decade. It started as discussions with company leaders regarding matters on the ballot at an upcoming shareholder meeting. Over time, it has evolved into a broader and deeper discussion with both directors and management on principle-based matters that go well beyond the year's ballot. This has made engagement a year-round process—not just a proxy season phenomenon—and has expanded its reach globally. Over the past year, we engaged with 721 companies, representing $1.6 trillion, or 47%, of our total fund equity assets under management."

- 2018 Investment Stewardship Annual Report

Dissatisfaction May Lead to Votes Against Directors

- **Passive investors** cannot sell assets in index funds for underperformance
- Instead, they generally **push for aspects of corporate governance that they believe are most clearly connected to long-term performance**
- Use **engagement and voting power to exert influence** with management in order to improve company (and therefore fund) performance
- *Compensation or other perceived issues may trigger negative votes even when company performance is strong*

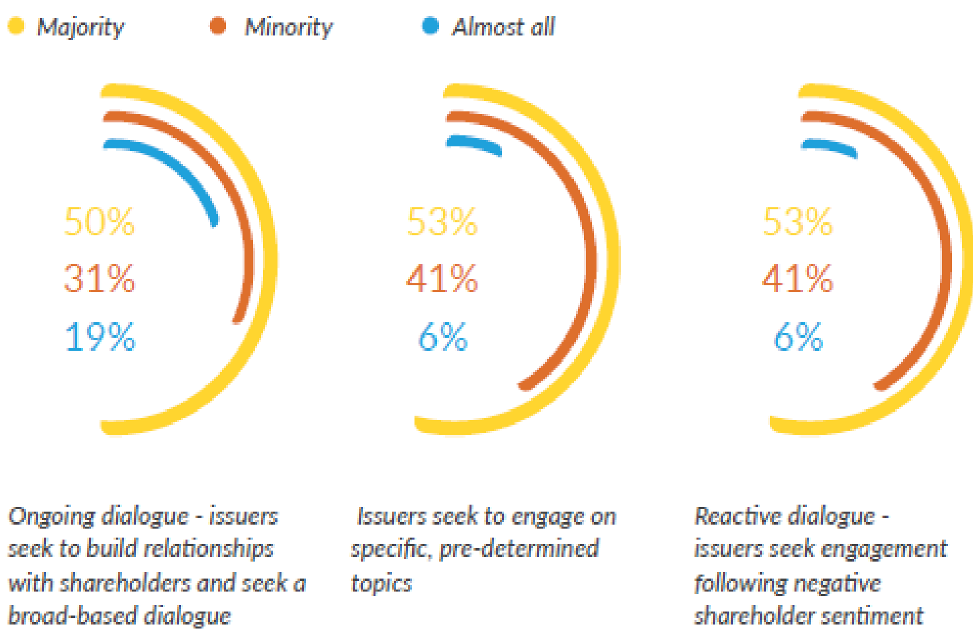
"If you're an active manager and you don't like what a company is doing, you sell it. If you're an index manager, you try to fix it."

- **Active investors** typically don't complain about corporate governance unless and until there is a corporate performance problem
- At that point, active investors are **quick to analyze board governance practices**
- Dissatisfaction with governance practices leads to **votes against directors and other proxy proposals**
- *Compensation or other perceived issues may trigger negative votes regardless of the reason for the corporate performance issue*

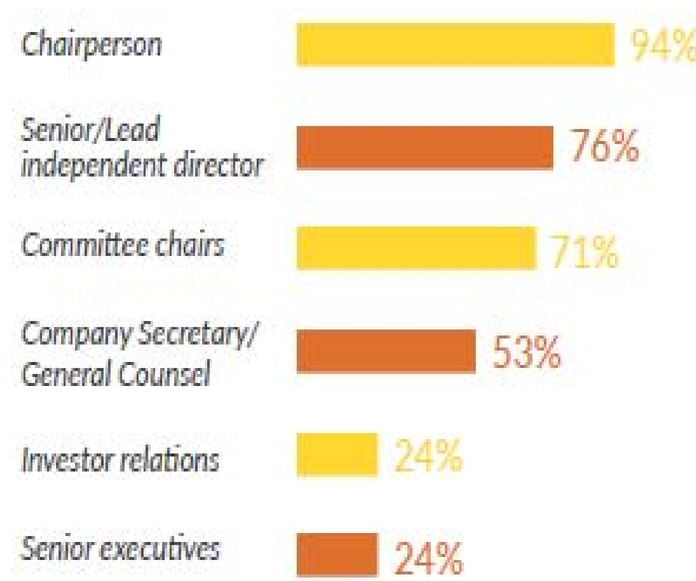
Investor Preferences

CMi2i 2018 Annual Investor Corporate Governance Report

What proportion of issuers seek the following types of engagement with our respondents?

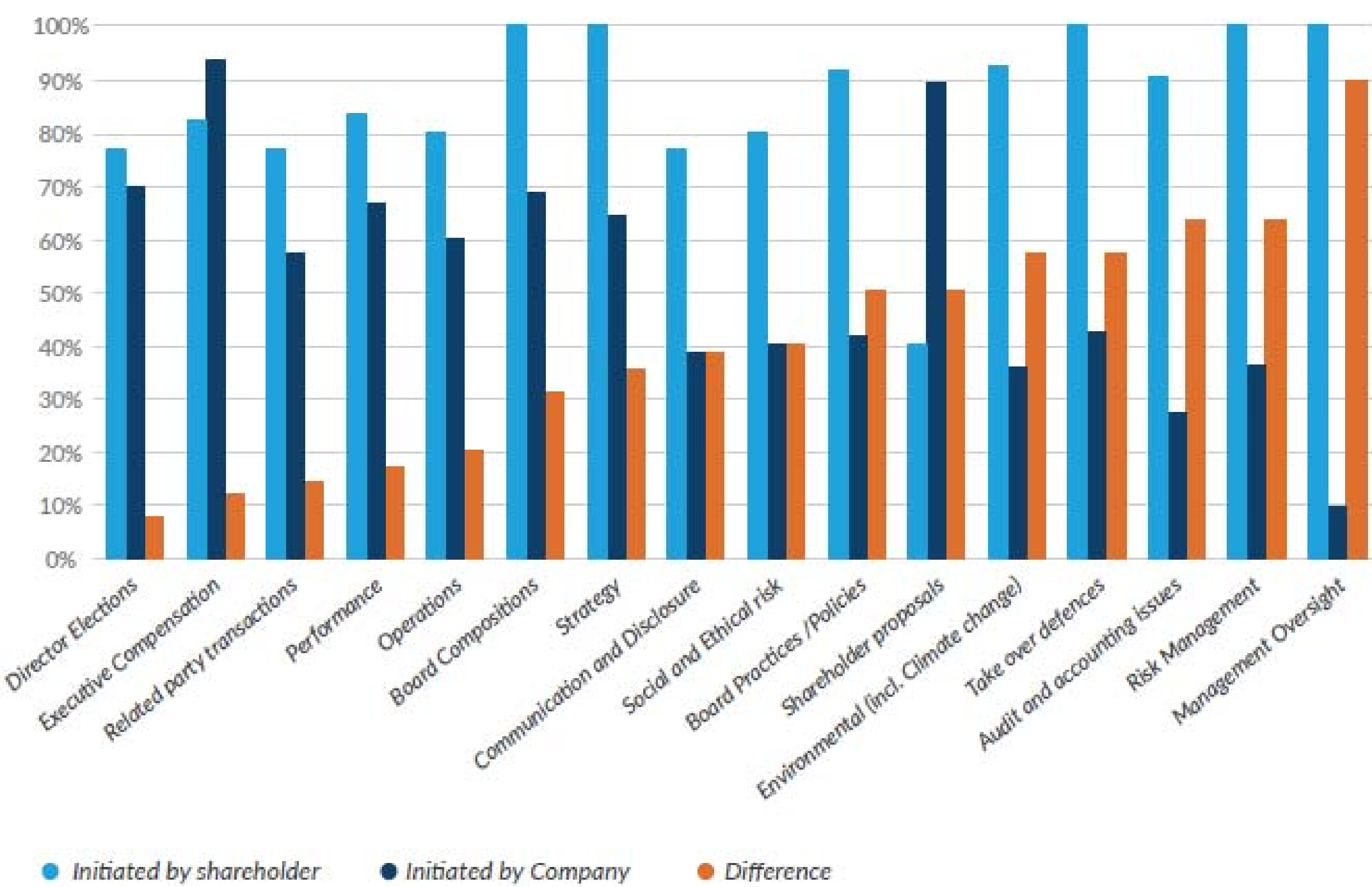


Who do respondents prefer to talk to regarding governance issues?



Engagement Topics: Companies vs Investors

CMi2i 2018 Annual Investor Corporate Governance Report



Shareholder Engagement – Advice for 2019

- Know *when* you need to engage
- Understand *why* you are reaching out to shareholders
- Determine *who* should be involved
- Have a targeted agenda, but be prepared to address other topics
- Understand each investors’ hot governance topics
- Technical reminders: be mindful about topics discussed and ensure compliance with Reg FD and filing requirements

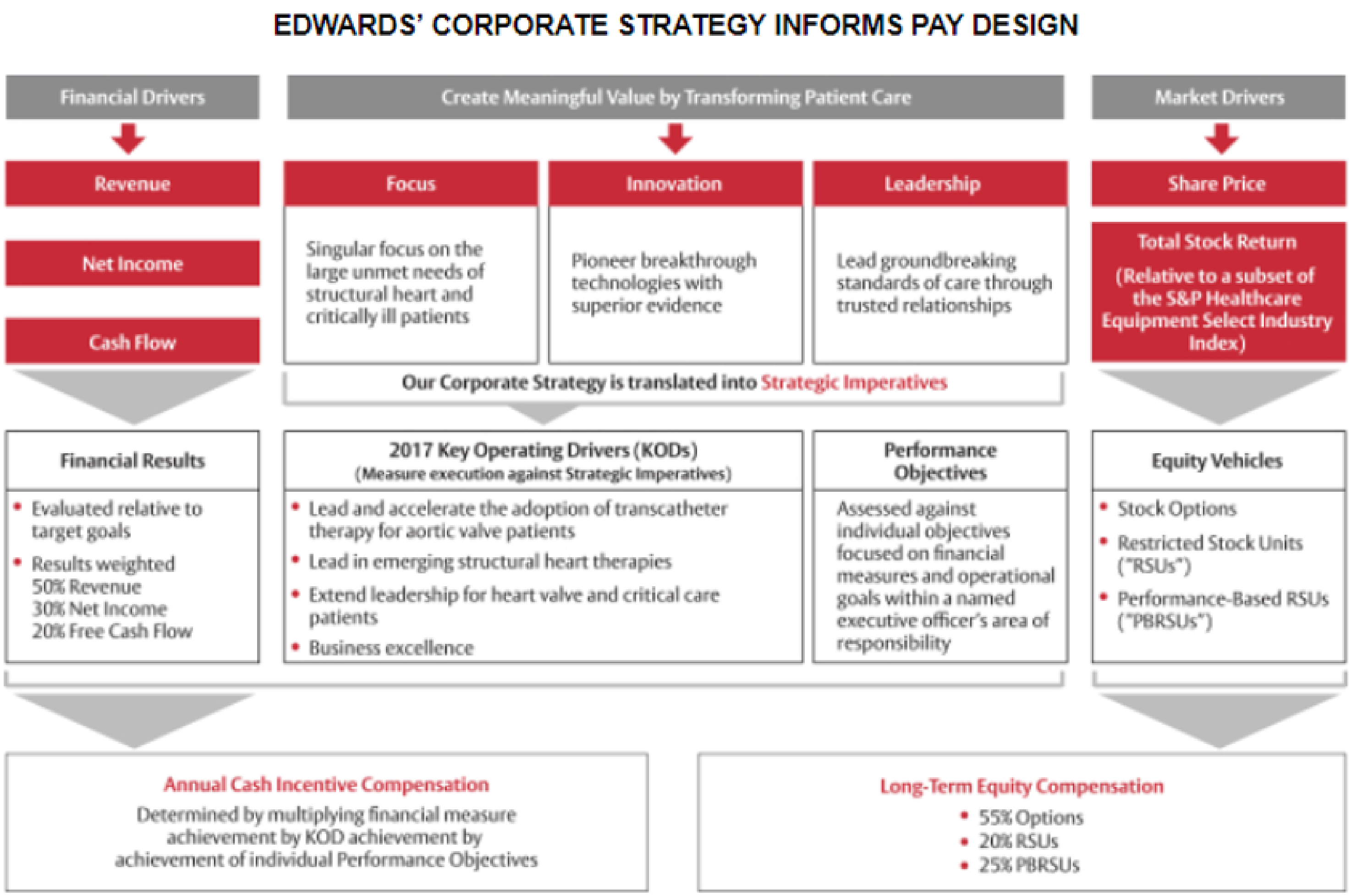

Disclosure

What Matters Most to Investors re Compensation Disclosure?

- Explanation of how pay is tied to long-term company strategy and performance
- Disclosure of performance goals, rigor of performance goals and company results justifying payout
- Peer group and benchmarking
- Response to last year's say-on-pay vote
- Egregious compensation practices

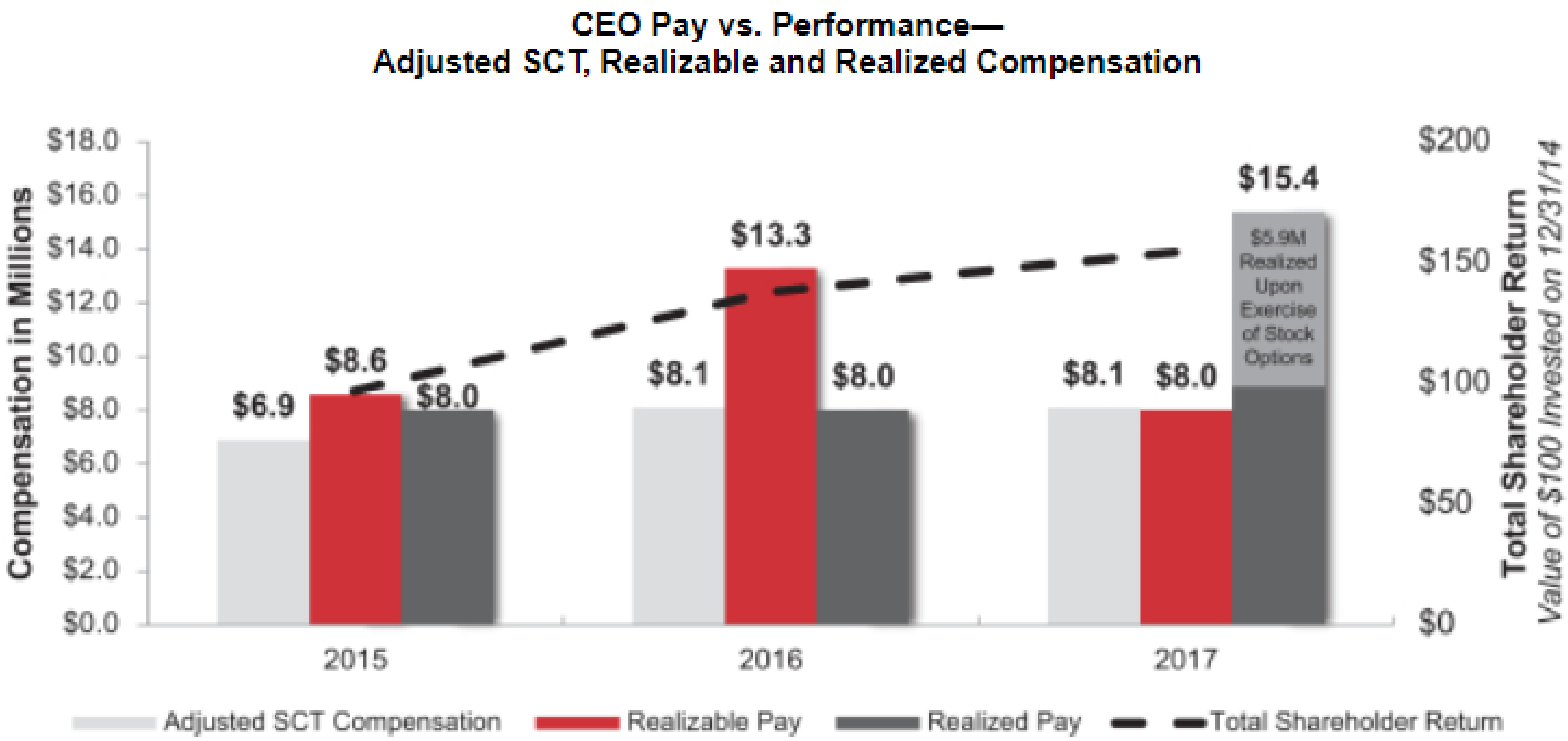
Example: Pay Supports Strategy

Edwards Lifesciences Corporation



Example: Pay for Performance Graph

KeyCorp



Example: Compensation Program Overview

Chevron Corporation

PAY ELEMENT	METRICS / PURPOSE	GOVERNANCE / TIMING
Base Salary	Fixed level of competitive base pay to attract and retain executive talent	
Annual Incentive Plan (Chevron Incentive Plan, or "CIP")	Recognize annual performance achievements in the following categories: • Financials • Capital Management • Operating Performance • Health, Environmental, and Safety	
Long-Term Incentive Plan ("LTIP")	Reward creation of long-term stockholder value using a balanced portfolio approach, with annual grants composed of three equity vehicles, each objectively measured and designed to focus recipients on different aspects of different stockholder value creation: • Performance shares: incentivize performance relative to peers; modifier varies from 0 to 200% based on relative TSR vs. large-cap energy peers and S&P 500; three-year performance cycle • Stock options: incentivize absolute performance and long-term value creation; three-year vesting, 10-year term • Restricted stock units: incentivize absolute performance and retention through long holding periods; five-year cliff vesting	
Benefits	Competitive retirement and savings plan benefits to encourage retention and support long-term employment	MCC and Board provide oversight of retirement/savings plan design and administration

GOVERNANCE / TIMING (Base Salary, CIP and LTIP):

4th quarter of preceding year
MCC, supported by independent compensation consultant, reviews competitive data; approves salary range, CIP and LTIP targets for executive officers except CEO

January each year
MCC and Board determine CIP and LTIP target for CEO; approve salary and LTIP awards for all executive officers

At the end of each year
MCC and Board approve CIP awards after performance results are evaluated against predetermined measures

At the end of 3 years
MCC approves performance share payout based on relative TSR performance

At the end of 5 years
Restricted stock units pay out based on absolute stock performance

Over 10 years
Stock options pay out based on absolute stock performance

Example: Response to Shareholder Engagement/Say on Pay

Motorola Solutions

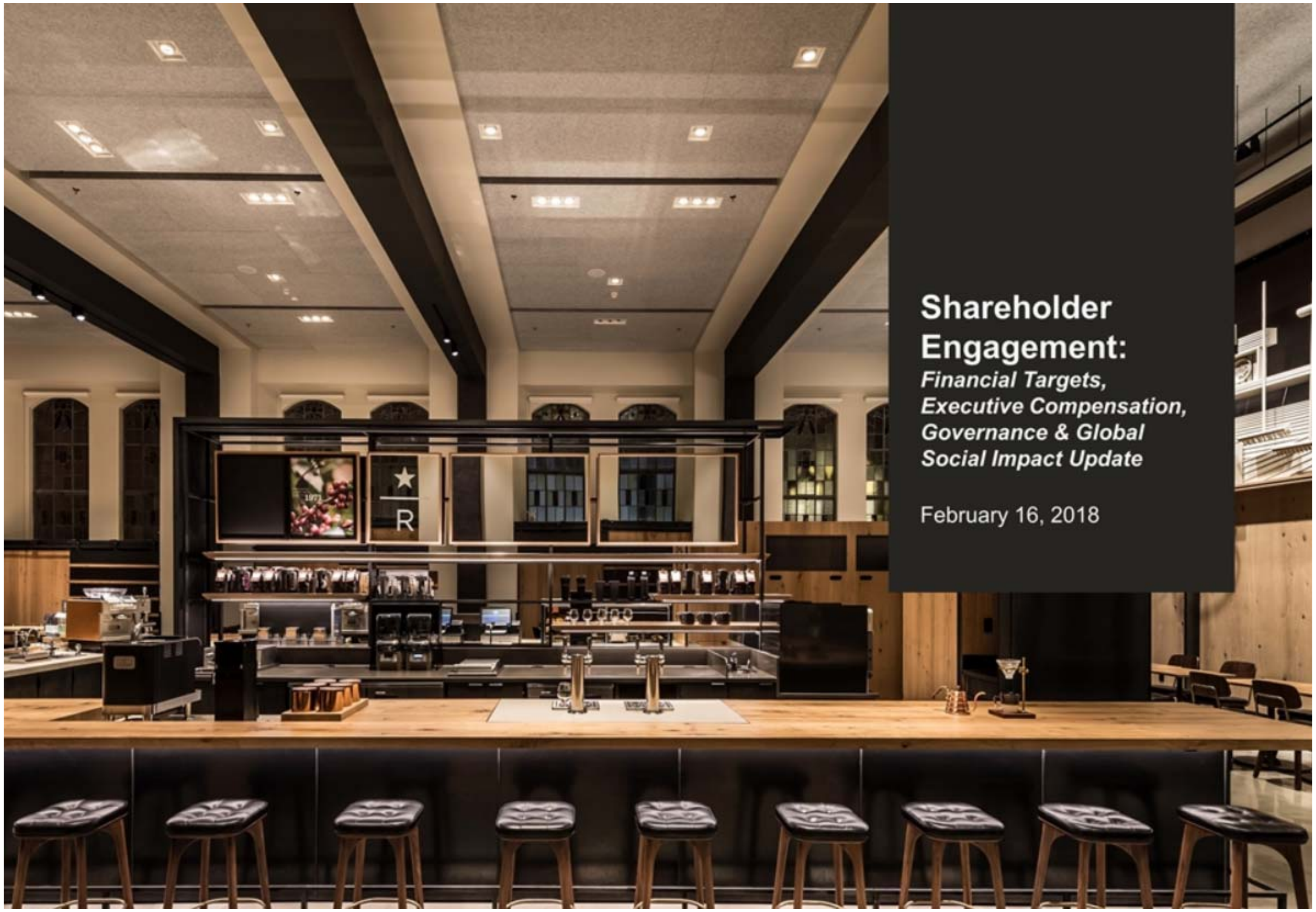
Response to 2017 Stockholder Vote and Stockholder Engagement Process

At the 2017 Annual Meeting, our stockholders approved the advisory vote on our executive compensation with 96% support. We believe this is in large part due to program changes over the past several years, which have resulted in a fundamentally sound program designed to drive our growth and align with overall stockholder interests.

PROGRAM CHANGE	2011	2012	2013	2014	2015	2016	2017
100% performance-based LTI program based on relative TSR and absolute stock price					All NEOs		
Performance-contingent vesting for equity grants		All NEOs	All NEOs	All NEOs	100% Performance-Based LTI		
Change in control plan with reduced benefits and elimination of excise tax gross-up	New Plan Approved (effective for new participants)			Effective (for participants following required notice period)			
Elimination of excise tax gross-up for CEO				CEO			
Extended stock ownership guidelines further down in organization	All Corporate VPs and above	Maintained					
Strengthened stock ownership guidelines for the Board of Directors	Implemented for Directors	Maintained					
Removed share recycling provisions from stock plan	Plan Revision Approved				Maintained in Plan Approved in 2015		
Significantly reduced equity eligible population to better align eligibility, share usage and equity expense with market		Implemented Reduced Eligibility	Maintained				

Example: Supplemental Proxy Filing

Starbucks



Advice for 2019

- Start early
- Address concerns raised by shareholders and influential proxy advisory firms
- Tell your pay-for-performance story
- Highlight positive facts (e.g., if you engaged, disclose it)
- Assess whether supplemental disclosure is right for your company (particularly newly-qualified SRC companies)
- Understand litigation risks
- Use plain English
- Don't forget the SEC rules
- Consider strategic use of supplemental proxy filing, if appropriate


Tax Reform

Status of Section 162(m)

- Section 162(m) prohibits public companies from deducting compensation paid to a “covered employee” that exceeds $1M per year
- Previously, exceptions to this rule were permitted for qualified “performance-based compensation”
- Tax reform at the end of 2017 eliminated the exception for “performance-based compensation” for taxable years beginning on or after 1/1/2018 and expanded the scope of “covered employee”
  - Certain compensation paid under a written binding contract in effect on 11/2/17 that is not materially modified may be “grandfathered”
- IRS issued guidance last week regarding “covered employee” definition and operation of the grandfathered rule; additional guidance remains forthcoming
- Exception for newly public companies for a reliance period following IPO currently remains intact

Impact of Tax Reform

- No more 162(m) equity plan proposals → number of companies submitting equity plan proposals decreased by 24%, according to ISS
- Companies weigh equity plan proposal strategies to preserve “grandfathered” compensation
- Companies weigh preservation of current 162(m) limits
- New litigation emerged over 162(m) language in CD&A and/or equity plan proposals
- Companies are making changes to their compensation structures

Advice for 2019

- Carefully review and re-assess proxy disclosure
- If submitting an equity plan, consider pros/cons of keeping limits
- Assess continued applicability of current limits
- Evaluate whether compensation structure changes are appropriate and consider implications
- Review compensation committee charter for any necessary updates
- Monitor IRS guidance and beware of any actions that could affect “grandfathered” compensation


Director Compensation

Litigation Developments & Impact

- Shareholder lawsuits continue, claiming breach of fiduciary duty against public company boards for engaging in self-dealing and corporate waste by approving their own pay at excessive levels
- Companies include a “meaningful limit” on director compensation in shareholder-approved equity plans as a strategy for deterring and defending claims
- *Investors Bancorp* decision raised questions about the effectiveness of limits
- What did we see in 2018?
  - Increased discussion at the board level
  - Equity plan proposals continued to include director compensation limits (more dollar-denominated limits, more limits on stock and cash)
  - Few companies set up formula plans with fixed grants
  - Companies carefully assess director compensation, with the use of a compensation consultant
  - Some companies have enhanced proxy disclosure

Investor/Proxy Advisory Firm Focus

- **ISS policy clarification**: beginning in 2019, ISS may recommend against directors who are responsible for setting or approving "excessive" non-employee director compensation in **two or more consecutive years** without compelling disclosure or other mitigating factors
  - **"Excessive"** means an extreme outlier and to determine outlier cases, ISS will compare individual non-employee director pay totals to the median of all non-employee directors at companies in the same index and industry
  - The purpose is to identify a pattern of extreme outliers, which historically has represented pay figures above the top 5% of all comparable directors
- ISS noted excessive pay in proxies during 2018

Director Compensation Proposals

- Some companies sought approval of director compensation in 2018
  - A few management proposals requesting approval of non-employee director compensation policies or programs
  - Some proposals are advisory
  - Mixed results
- ISS more deeply analyzed director compensation when a proposal was on the table, including analyzing items such as:
  - Relative magnitude of director comp compared to companies of a similar profile
  - Director stock ownership guidelines and holding requirements
  - Equity award vesting schedules
  - Mix of cash and equity-based compensation
  - Presence of meaningful limits on director compensation
  - Quality of disclosure surrounding director compensation

Example: Director Compensation Disclosure

OvaScience

- "...Specifically, in establishing the aggregate limits on compensation payable, the mix of cash and equity-based compensation, and the Holding Period requirement with respect to shares purchased upon exercise of options granted under the Director Compensation Policy, the Compensation Committee worked with its independent compensation consultant, Pearl Meyer and Partners LLC, to identify compensation trends in non-employee director compensation and amounts payable to non-employee directors by peer companies…The compensation payable for calendar year 2018 under the proposed Director Compensation Policy is in line with the median of peer non-employee director compensation programs presented by Pearl Meyer, and the new Holding Period required for the option shares is a leading practice among those presented programs. Our Board believes the proposed approach to compensation appropriately aligns the interests of our non-employee directors and our stockholders in the future success of the Company, while assuring we do not provide excessive compensation."

Director Compensation – Advice for 2019

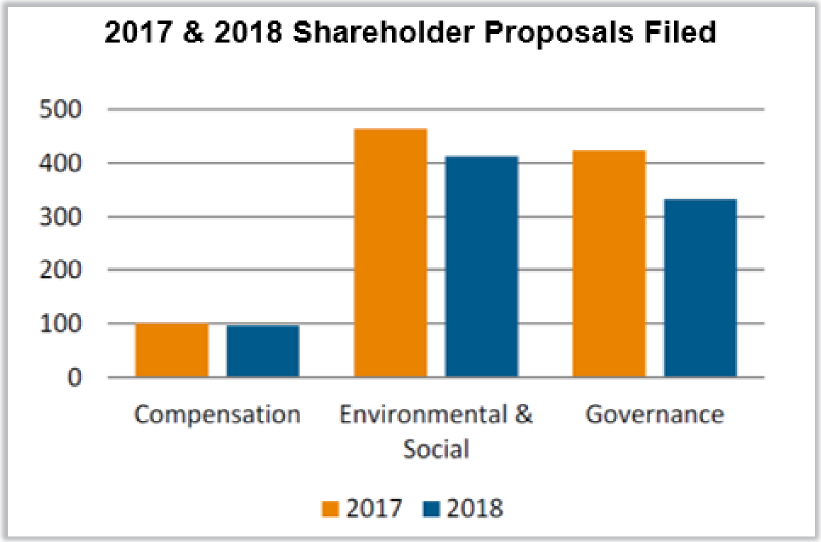
- Educate and discuss at board level
- Consider whether a limit in equity plan is appropriate; if a limit is proposed:
  - The limit should cover stock and cash and be expressed as a dollar value
  - Carefully evaluate appropriate size of limit to make sure it is “meaningful” and “reasonable”
- Ensure there is a ***rigorous process*** for setting director compensation:
  - Use of a compensation consultant
  - Annual review
  - Comparison against peers to confirm grants are in an appropriate range
  - Rigorous process around determination of peer companies
- Consider enhanced proxy disclosure describing the thoughtful process and any market-based analysis used to determine compensation

Shareholder Proposals

2018 Shareholder Proposals

- Number of proposals down, average support similar to 2017
- Zero compensation-related proposals passed, focus on other topics

- Governance-related proposals are dropping, but most likely to pass (70% of proposals receiving majority support are governance-related)
- E&S proposals are the most common, with increasing levels of support, but few pass
- Large-cap company focus (80% of proposals at S&P 500 companies)



Source: Alliance Advisors LLC

Compensation Proposals By the Numbers

Overall, compensation-related shareholder proposals DOWN from 2017 and 2016; *none have passed*

Compensation Proposal	# Submitted/# Voted On	Average Support	Comparison to 2017
Link pay to social issues	21/10	15.4%	Increase in proposals; increase in support
Clawbacks	13/8	38.3%	Increase in proposals; increase in support
Gender/Racial Pay Equity	27/5	14.8%	Decrease in proposals; increase in support
Retention of equity awards	1/1	28.1%	Decrease in proposals; increase in support
Revolving door payments	3/3	28.2%	Decrease in proposals; support flat
Accelerated vesting of equity awards	6/3	31.4%	Relatively flat

Data from Alliance Advisors LLC

Shareholder Proposals – Advice for 2019

- Take shareholder letters seriously, review with counsel and the compensation committee
- Know the rules/deadlines and SEC guidance
- Reach out to the proponent early in the process
- Continue to engage after the meeting


2018
2019

What to Watch

- Board composition and diversity, particularly gender
- Board refreshment
- Board compensation
- Change to definition of “smaller reporting company”
- Pay ratio year two
- ISS and Glass Lewis policy changes
- Virtual-only annual meetings

Looking Forward: Possible 2019 ISS Policy Changes

The ISS 2018 policy survey is now open, providing a first glance into policies ISS is considering changing or adopting for the 2018 proxy season:

- **Shareholder proposals seeking independent board chair:** reevaluating the factors considered when determining whether to support these proposals
- **Minimum stock ownership requirements for bylaw amendments:** considering appropriateness of minimum stock ownership requirement (in excess of Rule 14a-8) for shareholders who want to propose binding amendments to bylaws
- **Pay-for-performance:** exploring ways to improve the financial metrics used in the analysis and supplementing or replacing existing GAAP-based accounting metrics with "economic value added" based metrics to measure "true underlying economic profit and capital productivity"
- **Non-employee director pay**: considering what rationales would justify high non-executive director compensation for two consecutive years to avoid a negative recommendation in 2019

Looking Forward: Possible 2019 ISS Policy Changes (cont'd)

- **Board qualifications matrix**: considering what level of disclosure about a director's individual skills and attributes would be most useful to shareholders
- **Gender diversity on boards:** again considering whether board diversity should come into play for director recommendations
- **Auditors and audit committees**: considering what other audit-related factors could be considered in evaluation of the independence and performance of the external auditor (in addition to non-audit serves and fees) and what information should be considered in evaluating the audit committee
- **Director accountability and track records**: considering whether an individual director's failure in oversight responsibilities at one company should result in a negative recommendations for other current or future boards and if so, what types of oversight shortfalls would be relevant and the appropriate look-back period
- **One-share, one-vote principle**: considering presenting adjusted vote results where possible and what is an appropriate timeframe for sunset provisions for multi-class capital structures with unequal voting rights

Reid Pearson, Alliance Advisors
rpearson@allianceadvisorsllc.com

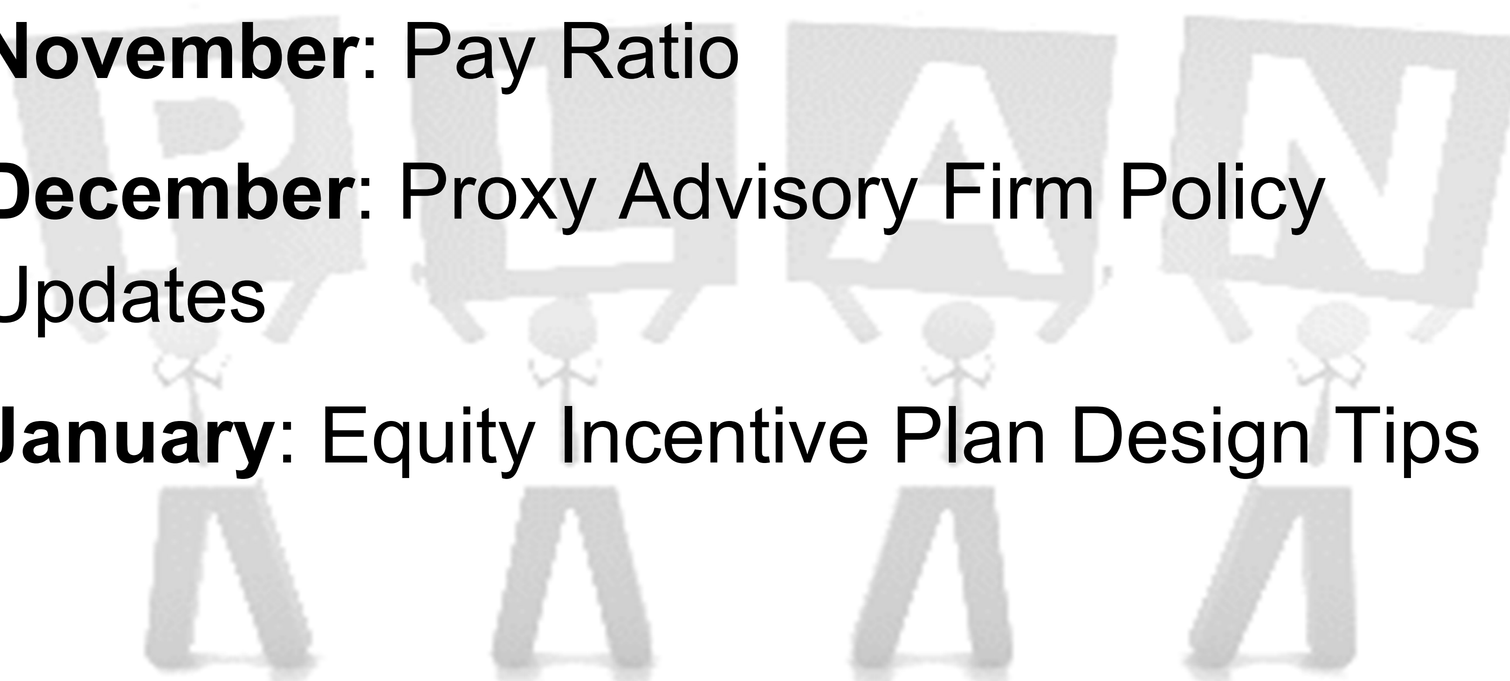
Megan Arthur Schilling, Cooley
marthur@cooley.com

Amy Wood, Cooley
awood@cooley.com

Cooley

Future Comp Talk Programs

- **September 19**: Director Compensation
- **October**: International Equity Awards
- **November**: Pay Ratio
- **December**: Proxy Advisory Firm Policy Updates
- **January**: Equity Incentive Plan Design Tips



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