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What We Learned from the 2018 Proxy Season

Another proxy season has wrapped up and, with it, the eighth year of say-on-pay votes are in the books for most public companies. Negative vote recommendations for say-on-pay proposals from Institutional Shareholder Services, Inc. (ISS) and Glass Lewis & Co. (Glass Lewis) went up slightly—as did the number of outright say-on-pay failures for both the Russell 3000 Index and S&P 500 Index. When it comes to equity proposal votes, ISS and Glass Lewis models are not always needed for sufficient shareholder support. Companies can obtain necessary shares to adequately fund their programs by engaging directly with their shareholders—even in the face of receiving negative recommendations. In any case, for both say-on-pay and positive share plan proposals, it all comes down to planning ahead.

Below, we examine the 2018 Proxy Season, from existing negative trends in say-on-pay, to the growing complexity of proxy advisory firm models, what this means for share authorizations, and recommended next steps to prepare your firm for future proxy season success.

Say-on-Pay

Declining support for say-on-pay in 2018 marks a departure from the improvement we saw starting in the 2015 proxy season. The number of GICS 4010 Banks within the Russell 3000 failing to obtain majority approval for executive compensation packages jumped from three failures for all of 2017 to five through mid-July 2018. In addition, ISS Governance Analytics against vote recommendation rates reached 13.19% in 2018, versus 10.24% in 2017 for these firms. Meanwhile, average shareholder support for pay has fallen from 93.16% to 91.12% for GICS 4010 banks. Following a similar pattern to prior years, we expect the negative vote recommendation for ISS to decline as we approach the end of 2018.

Say-on-Pay Trends at GICS 4010 Banks	**2018**	**2017**	**2016**	**2015**	**2014**
Percentage of ISS against recommendations	13.19%	10.24%	11.74%	9.33%	13.10%
Percentage of failures	2.10%	1.20%	0.9%	2.30%	1.70%
Percentage of average shareholder support	91.12%	93.16%	91.40%	91.55%	91.25%
Number of failures	5	3	2	5	4

Aside from quantitative pay-for-performance misalignment, other issues contributing to lower say-on-pay support include:

- Inadequate disclosure around short- and long-term incentive goals
- Lowered incentive goals without adequate rationale
- Increased target incentive opportunities when underperforming relative to the industry
- Large one-off grants without sufficient rationale and / or risk-mitigating design features
- Above median benchmarking (especially when using outsized peers)

Approximately 8% of all Russell 3000 companies have triggered ISS' Board Responsiveness Policy for the 2019 proxy season—whereby the firm expects companies to disclose their process for shareholder engagement and actions taken in response to any vote below a 70% threshold. Meanwhile, 13% of Russell 3000 companies have triggered Glass Lewis' board responsiveness threshold to any vote below an 80% threshold, which increased from 70% last proxy season.

Further complicating companies' messaging to investors is ISS' brand new secondary quantitative CEO Pay-for-Performance filters, called the Financial Performance Assessment (FPA). This screening measures a company's performance outside of total shareholder return and pay levels relative to its ISS-generated pay-for-performance peer group. ISS uses three to four designated financial metrics to assess a company's performance under the FPA in each industry. Since the firm uses non-adjusted GAAP metrics, the application of this testing to companies with significant M&A or corporate restructuring activity resulted in poor pay-for-performance scoring in 2018. In many cases, these companies had strong total shareholder return results.

Companies that failed to obtain majority approval in 2018 or fell below one or both proxy advisory firms' Board Responsiveness Policy thresholds will be expected to disclose in 2019 that they engaged with shareholders to understand their concerns and took action. Absent of such action and related disclosure, companies face possible negative vote recommendations for both say-on-pay and the reelection of compensation committee members. Even if a company is technically above the proxy advisory firm voting thresholds for these policies, it is good practice to engage with investors if your say-on-pay results have gone down from the prior year, as this indicates increased investor dissatisfaction with some element of your pay program.

Share Plan Proposals

For years, companies have been told, or at least many companies believe, that they must pass the ISS and even the Glass Lewis models to obtain sufficient shareholder support for a share request proposal. As the complexity of the proxy advisory firm models increases each year and the applicable allowable dilution and burn rate thresholds get more stringent, it is becoming increasingly difficult for companies to obtain market competitive share pools, while also passing these models. In fact, many companies find that even if they adopt virtually all restrictive ISS-deemed best practices for plan features or grant practices, they can obtain only limited share pools.

For instance, companies with significant share buyback activity or relatively low common shares outstanding generally have a hard time passing each firm's dilution and run rate policies, regardless of whether the lower common shares outstanding benefit shareholders or not. Alternatively, companies with very high outstanding underwater stock option balances in the overhang, which don't generally provide any retentive value to the holder, also have difficulty passing both the ISS and Glass Lewis dilution cost tests.

ISS Governance Analytics recommended against approximately 24% of all share request proposals this year and Glass Lewis recommended against approximately 20%. Yet, only a handful of companies are actually failing, and this is usually under fairly egregious circumstances. These statistics show that companies can successfully obtain the shares needed to adequately fund their programs by engaging directly with their shareholders—despite receiving negative recommendations from ISS and possibly Glass Lewis as well.

Now, that isn't to say that investors do not also have their own default proxy voting policies, many of which overlap with the ISS and Glass Lewis policies, because they do. However, unlike ISS and Glass Lewis, which tend to take a hardline stance on such topics, meaning you either pass or fail their policies, investors are often willing to consider company specific factors that should mitigate the noted proxy advisory firm concerns. As such, the sooner a company conducts modeling and determines that a non-proxy advisory firm compliant pool makes the most sense, the better. This allows a company to proactively craft their story in the proxy proposal language and to engage with investors with sufficient messaging to counter the likely negative ISS and / or Glass Lewis recommendations.

Equity Plan Authorization Votes: Russell 3000 Index	**2018**	**2017**	**2016**	**2015**
Percentage of ISS against recommendations	23.64%	21.27%	25.49%	22.19%
Percentage of average shareholder support	87.99%	89.21%	88.70%	89.81%
Percentage of failures	0.4%	0.6%	0.4%	0.1%
Number of failures	2	5	3	1

The statistics above show that regardless of increased negative ISS vote recommendations from 2017 to 2018 (i.e., 23.64% in 2018 versus 21.27% in 2017), the number and percentage of companies failing to obtain the necessary approval percentage declined year-over-year from 0.6% (five companies) to 0.4% (two companies). The reality is that despite a relative high percentage of against vote recommendations from ISS, most companies can obtain necessary shareholder support in the Russell 3000 Index and beyond. The story is even stronger for GICS 4010 banks, as depicted below. While this vertical has seen a large increase in negative votes over the past year from 18.31% to 28.07%, there have been no failures in equity plans over the past four years.

Equity Plan Authorization Votes: GICS 4010 Banks	**2018**	**2017**	**2016**	**2015**
Percentage of ISS against recommendations	28.07%	18.31%	22.45%	19.44%
Percentage of average shareholder support	90.61%	91.48%	91.61%	91.27%
Percentage of failures	0.00%	0.00%	0.00%	0.00%
Number of failures	0	0	0	0

Some of this is due to self-selection, with companies that have poor fact patterns waiting to go back for shares when their fact patterns improve, i.e., performance improves, dilution profile improves, etc. Some are also taking advantage of the inducement grant listing exchange exception, changing their long-term incentive mix, or taking other actions to extend the life of the share pool.

When deciding how many shares to request in your plan, we recommend a two-step approach:

1. To start, it is extremely important for companies to gauge how many shares they will likely need in the next one to two, maybe three, years to adequately fund market competitive grants throughout the organization. This process often requires some forecasting in headcounts, long-term incentive mix possibilities, as well as share price movement possibilities.

2. Then, it is helpful to assess the company's equity profile and grant practices relative to the ISS, Glass Lewis, and top investor policies. If your company easily passes either the ISS or Glass Lewis models, the road to obtain the necessary approval for a request tends to be a little easier. If you find that your company is not easily passing the proxy advisory firm models, it is important to see if any low hanging fruit plan features or grant practices could be easily adopted to gain sufficient shares and proxy advisory firm support. If a company finds that it must adopt too many restrictive plan features for a small number of shares, this is a prime example of when the organization should seek a non-proxy advisory firm compliant pool.

Looking Ahead

Given the continued focus on pay-for-performance, it is important that companies continue to monitor their exposure relative to investor and proxy advisory firm policies. Whether it's on say-on-pay, share plan proposals, or other proxy votes, companies need to assess the pros and cons of moving ahead without a proxy advisory firm recommendation or making modifications necessary to securing an affirmative recommendation. Regardless of the approach taken, shareholder outreach is critical to obtaining higher support levels.

To remain proactive on this topic and gain valuable insights for the 2019 Proxy Season, please contact our team.

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