Mid-Season Update on the 2012 Proxy Season

Overview

The 2012 proxy season in the United States, forecast by some to feature significant turmoil and change, has in fact been less tumultuous than expected. It's been all quiet on the regulatory front, owing to the SEC's highly deliberate approach to rulemaking and the D.C. Circuit's interventionist reaction to the proxy access rules. With new rules, for once, not in motion, change is occurring incrementally, as activists continue old campaigns and launch new ones, institutional shareholders express their support on both the issues and the circumstances of particular companies, and the companies themselves decide when to resist and when to negotiate.

Continued Support for Say-on-Pay Votes

Obtaining say-on-pay support continues to be a nonissue for many companies. Of the 639 large accelerated filers to report results as of May 18th, only 2% failed their say-on-pay votes, the same percentage that we saw in 2011. Less than 16% of large accelerated filers reported say-on-pay results below the 80% approval level and less than 10% reported results below the 70% approval level. The continued high pass rates may reflect not only the tactical judgment of shareholders to force the issue at only a handful of companies, but also the retreat at many companies from practices that had drawn the most criticism, such as tax gross-ups and excessive severance. Many companies also increased their engagement with shareholders and have done a better job of explaining their pay practices.

For the 15 large accelerated filers that did not win approval of their executive compensation, the common explanation was a perceived pay-for-performance disconnect that caused one or more negative recommendations from proxy advisory firms. Often, the failed votes were the result of targeted efforts by institutional investors on a small number of companies.

Use of Additional Soliciting Materials

The 2012 proxy season has seen an increase in the use of additional soliciting materials by companies to solicit favorable say-on-pay votes. While a few companies file such materials on the heels of their proxy statement, many companies do so only in response to negative recommendations on say-on-pay votes from proxy advisory firms. Many of these supplemental materials address perceived flaws in the ISS pay-for-performance analysis (such as peer group selection), and some address what companies believe are factual inaccuracies.

Proxy Access

With statutory proxy access on the shelf for the foreseeable future, the action has turned to "private-ordered" proxy access, with 21 proxy access proposals filed with companies this season, including binding and nonbinding proposals. The proposals generally followed the structure of the SEC's invalidated Rule 14a-8(b), with variations in the required ownership thresholds and holding periods.

The SEC agreed that nine of these proposals could be excluded from the proxy statement but, as has often been the case in the Rule 14a-8 arena, the SEC's reasoning varied from case to case, making predictions difficult. The SEC supported exclusion of the most common form of proxy access proposal, a precatory proposal requiring 1% stock ownership for two years based on a model from the U.S. Proxy Exchange. In some cases the proposal was excluded as "vague and indefinite" (because it didn't explain the eligibility requirements of Rule 14a-8(b)); in other cases the proposal was excluded because it was deemed to contain multiple proposals (because it included a proposal that an election of proxy access nominees would not be considered a change in control). On the other hand, the SEC denied no-action relief to companies seeking to exclude binding proxy access proposals by Norges Bank that required 1% ownership for one year, rejecting the argument that a reference to an inactive webpage in the proposal rendered it vague and indefinite. The SEC also denied a request to exclude a binding 2%/one-year proposal, rejecting the argument that the proposal was "substantially implemented" by the company's adoption of a bylaw that gave proxy access to 5% shareholders.

Of those that remained on ballots, to date there have been three reported votes, the most successful of which received 33% support at Wells Fargo. Three other companies have held votes but have not yet reported results. In addition, one major company, Hewlett-Packard, agreed to put forward its own management proposal in 2013 in exchange for the withdrawal of a proposal this year. We expect this to be an area of increasing activity in 2013.

Settling Before the Vote

As has been the trend for the last few years, many companies negotiated settlements with shareholder proponents to avoid the time and expense of defending themselves and the risk of loss, particularly in areas where there is a strong track record of shareholder support, such as majority voting and declassification proposals. Forty-four S&P 500 companies have negotiated agreements to offer management proposals to declassify their boards after receiving declassification proposals, according to the Harvard Law School Shareholder Rights Project. Likewise, six companies facing proposals seeking auditor independence reports have agreed with proponents to provide audit firm independence statements, according to the United Brotherhood of Carpenters.

Because the proxy advisory firms' recommendation often comes late in the soliciting cycle, oftentimes with just a couple of weeks before the meeting, our advice to companies is to prepare materials in advance if there is a perceived risk of a negative recommendation.

Other Governance Proposals

There has been a modest increase in support for a number of corporate governance proposals this year so far, including such hardy perennials as board declassification (average of 79% support), independent chairman (37%) and majority voting (67%), all increases over last year's proxy season results. The push for declassified boards remains mostly with large-cap companies. Approximately two-thirds of S&P 500 companies already have declassified boards, and declassification proposals at large-cap companies continue to be resoundingly successful, largely due to targeting by shareholder activists. But this war is being fought one skirmish at a time, and the activists have so far generally focused primarily on large-cap companies that still have classified boards. As a result, the classified board is very much alive, and, in fact, according to a recent Davis Polk survey, some 78% of IPO companies during the past two years have had classified boards.

Emergence of the "Shareholder Spring"

A number of mostly large-cap companies, particularly in the financial sector, experienced Occupy Wall Street-inspired demonstrations at their annual meetings this spring. Complaints included items that were mostly off the shareholder ballot, ranging from mortgage- and consumer-related issues to companies' tax minimization strategies to calls for more disclosure of corporate spending on political activities. This was actually, however, much more about street theatre for media attention than about actually affecting the voting outcomes, given that almost all the votes are already cast by the time the meeting occurs. Even at Wells Fargo, where protesters also complained about executive compensation, the say-on-pay votes passed with 96%.

Delays in SEC Rulemaking

The SEC, buried in the avalanche of Dodd-Frank and JOBS Act rulemaking, has yet to come forward with rules relating to conflict minerals, CEO pay ratios, clawbacks, pay-for-performance disclosure and compensation committee independence, among other topics. The slowdown is in part due to the increased focus on cost-benefit effects in light of the D.C. Circuit decision vacating mandatory proxy access. This seems especially true of conflict minerals and pay ratio rules, where the costs may be high and the benefits negligible.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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