# LIGHTHOUSE

MORROW SODALI

JULY 2019 | US EDITION

# 2019 PROXY SEASON REVIEW

- Shareholder proposal review
- Overboarding and board diversity
- Say-on-Pay
- Short interest and shares on loan
- Virtual shareholder meetings

*Welcome to the U.S. edition of Morrow Sodali's Lighthouse. Inside this issue, we review the critical trends of the 2019 Proxy Season, taking a closer look at key issues and factors influencing voting decisions. This season's statistics and insights contain valuable lessons for corporations as they begin their planning for 2020. We hope you enjoy this issue and please do not hesitate to contact us if you have any questions.*

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# 2019 Shareholder Proposals

Overall, the volume of shareholder proposals has remained consistent over the past few years. Proposals related to what many investors consider mainstream governance practices – declassifying the board, reducing supermajority vote requirement and requiring majority voting on director elections - continue to be viewed favorably by investors. The right to call special meetings and proxy access have been widely adopted by issuers, which has reduced the number of proposals requesting companies adopt these rights but that has not deterred proponents from offering their own versions through "fix-it" proposals. This year showed a slight decrease in environmental-focused issues while social issues, including board diversity and gender equality, trended upward. The main shareholder proposal trends during the 2019 proxy season are highlighted below, broken down in two sections - governance and environmental/social proposals.

## GOVERNANCE PROPOSALS

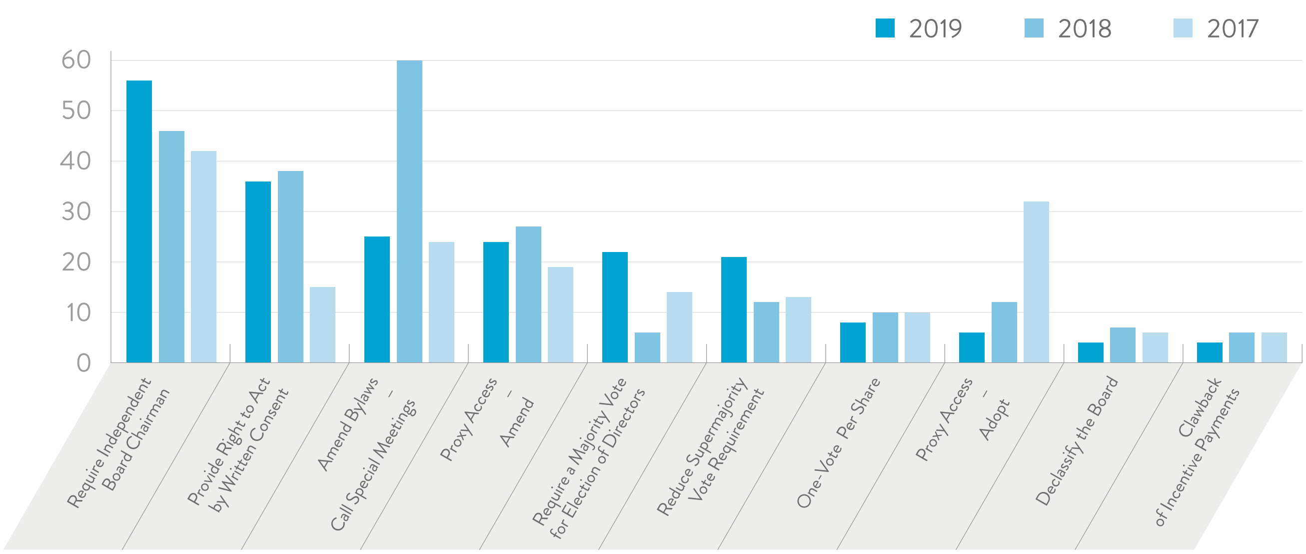



Figure 1: Chart represents common shareholder proposals voted on at companies within the Russell 3000 through July 1, 2019. Chart does not include shareholder proposals submitted and later withdrawn.

## INDEPENDENT BOARD CHAIR

The number of Independent Chair proposals continued to increase in 2019. Though volume increased, not a single proposal received majority support and average support decreased from 31% in 2018 to 29% in 2019. Disclosure regarding the role of the Lead Independent Director remains a crucial factor in defeating this proposal. Clearly defined duties of the Lead Independent Director, along with good financial/stock price performance and robust governance practices, are key to gaining support from institutional investors and advisory firms.

## WRITTEN CONSENT

Since 2017, the number of proposals related to shareholders' right to act by written consent has increased substantially from 15 in 2017 to 36 in 2019. Average support this year was 39% and six proposals received a majority of the shares voted in favor. The success of this proposal is often tied to whether a company allows shareholders to call a special meeting. Many companies provide shareholders the right to call special meetings which, in some cases, is enough to gain support from advisory firms and institutions in defeating the written consent proposal. According to ISS and Glass Lewis policy, one of the factors considered when making a recommendation regarding a written consent proposal is whether shareholders have the right to call special meetings at a 10% threshold. While ISS and Glass Lewis are strict on the 10% threshold, some large institutional investors are not as stringent, though policies vary firm to firm.

## REDUCE OWNERSHIP THRESHOLD FOR SHAREHOLDERS TO CALL SPECIAL MEETINGS

Shareholders' ability to call special meetings is considered a fundamental shareholder right. It gives shareholders the opportunity to adequately address concerns while giving the company more control of the process than by written consent. While many companies provide shareholders this ability, the minimum ownership threshold required to call a special meeting is still up for debate. The proposal at **Rite Aid Corp. (RAD)** was the only proposal aiming to reduce the threshold to 10% that passed. Excluding RAD, the approval rate for proposals seeking a 10% threshold ranged from 35% to 45% of the shares voted on the proposal. Those calling to reduce the threshold to 15% or 20% had more success, with four receiving a majority of the votes cast. Two proposals were narrowly defeated, receiving over 48% support. Company specific factors including size, performance, existing anti-takeover provisions and responsiveness to shareholders are all considerations for institutions and advisory firms when considering these proposals.

## REDUCE SUPERMAJORITY VOTE REQUIREMENT

The elimination of supermajority voting thresholds has consistently received high levels of support from shareholders. Although shareholder proposals consistently pass, it can be hard for companies to garner enough support if put up as a management proposal in the following year. Ownership structure plays a vital role in determining the success of these management proposals, as the supermajority vote requirement is nearly impossible to reach without substantial participation from all shareholder groups.

## PROXY ACCESS

In 2016, GAMCO Investors, Inc. was the first investor to make use of Proxy Access when they submitted a nomination to the board of **National Fuel Gas Company (NFG)**. Due to technicalities within **NFG**'s proxy access bylaw, the nomination was withdrawn before going to a vote. This year, the first proxy access vote took place at **The Joint Corp. (JYNT)** annual meeting. The Austin Trust nominated Glenn J. Krevlin who, with the support of the board, received 99% of the votes cast in favor. It is not unusual for Mr. Krevlin, the founder of Glenhill Capital Advisors, to influence change at companies he has invested in. Interestingly, Steven Colmar, the trustee of the Austin Trust, is a co-Founder of **JYNT** and served on the board from 2010 to 2017. He is also the brother of the company's Secretary, Craig Colmar.

Proposals to adopt proxy access have decreased, though "fix-it" proposals remain relevant. ISS will typically support a fix-it proposal while Glass Lewis will generally recommend a vote against if they consider the Company's version of proxy access to be sufficient. The formula considered best practice is an ownership threshold of 3% of the outstanding shares, held for a period of at least 3 years, with a group size of up to 20 holders and the ability to nominate the greater of 20% of the board or 2 seats. Most fix-it proposals focus on eliminating the limit of the nominating group and increasing access to the board from 20% to 25%. Average support for fix-it proposals in 2019 was 28%, consistent with previous years.

## ENVIRONMENTAL & SOCIAL PROPOSALS

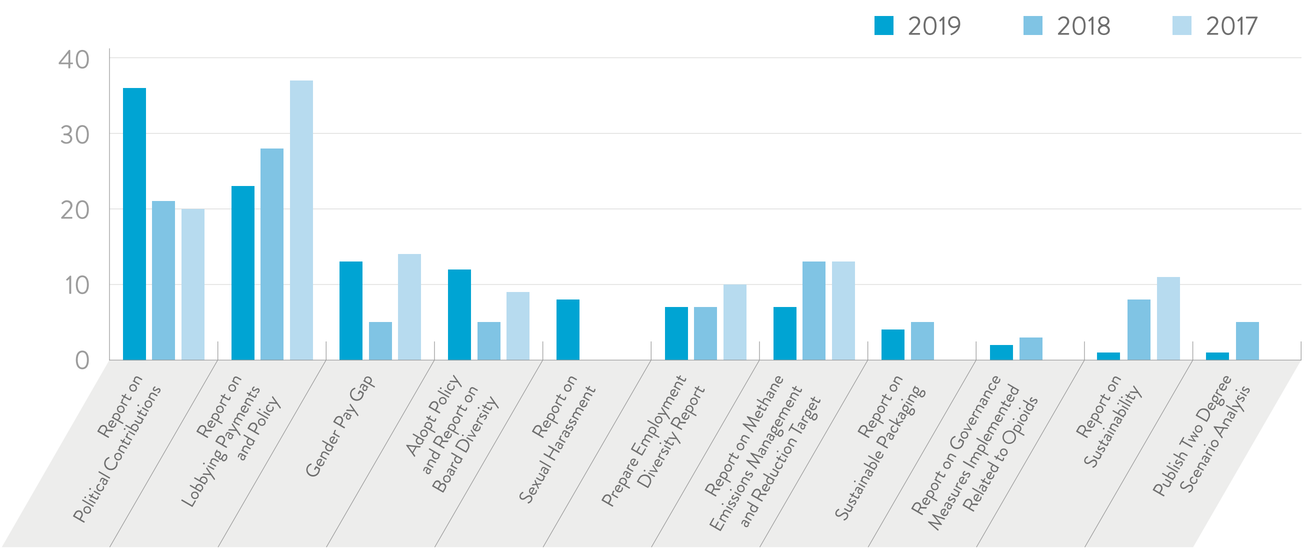



Figure 2: Chart represents common shareholder proposals voted on at companies within the Russell 3000 through July 1, 2019. Chart does not include shareholder proposals submitted and later withdrawn.

## POLITICAL CONTRIBUTIONS/LOBBYING

Proposals calling for reporting on political contributions are on the rise. Compared to last year, an additional fifteen proposals were submitted, with two receiving a majority favorable vote (as opposed to none in 2018). Shareholders of **Alliant Energy Corp. (LNT)** and **Cognizant Technology Solutions Corp. (CTSH)** supported the proposals calling for the companies to publish reports on political contributions with each proposal receiving support from over 53% of the shares voted. Another twelve proposals received support in the 40-49% range. **Macy's, Inc. (M)** narrowly defeated the proposal, which received 49% support. This proposal, however, would have passed if abstentions were not considered votes against the proposal. Average support for lobbying proposals was 30%. The Board of **Mallinckrodt plc (MNK)** recommended a vote in favor of the shareholder proposal, stating significant efforts were under way


to produce a “Political Engagement Report” that would be very similar to the type of report requested as part of the shareholder proposal. With support from the Board, the proposal received a favorable vote of 79% of the votes cast.

## SEXUAL HARASSMENT

New this proxy season were proposals calling for reporting related to Sexual Harassment. The allegations involving Chair/CEO Leslie Moonves of **CBS Corporation (CBS)** brought the #MeToo discussion to the board level. **CBS** is now facing a shareholder lawsuit declaring board negligence in relation to the sexual harassment allegations. Several big-name companies faced shareholder proposals related to this topic including, **Alphabet, Inc. (GOOGL), Amazon.com Inc. (AMZN), Walmart, Inc. (WMT)** and **XPO Logistics, Inc. (XPO)**. Although average support was 15%, the proposal at **AMZN** would have received over 40% without insider shares held by Jeff Bezos.

## GENDER PAY GAP

One of the biggest upward trends in the ESG space is the discussion surrounding gender pay. Gender pay proposals have evolved to include measures on the median gender pay, not just equal pay, as they have in the past. Median gender pay focuses on the number of women in high-paying leadership roles as opposed to equal pay which measures salary on a peer level. The goal is to increase female representation on all levels, including the executive level.

There have been several proponents of gender pay proposals, most notably, Arjuna Capital and NYC Pension Funds. Average support in 2019 was 24%, up from 14% in 2018. Arjuna Capital targeted financial leaders including, **The American Express Company (AXP), Bank of America (BAC), The Bank of New York Mellon Corp. (BK), JPMorgan Chase & Co. (JPM) Mastercard, Inc. (MA) and Wells Fargo & Co. (WFC)** and influential technology firms including, **Adobe, Inc. (ADBE), Alphabet, Inc. (GOOGL), Amazon Inc, (AMZN),** and **Facebook, Inc. (FB)**. Commitments from both issuers and institutional investors suggests this is a topic that will continue to form and take shape in the coming years. **American Express**, for example, dedicates an entire section on diversity and inclusion on their Company website, which contains on overview of diversity policies at **AXP** as well as links to several interesting news articles on the topic.

## DIVERSITY

Eight proposals requesting companies disclose a board diversity and qualifications matrix went to a vote in 2019, up from just two voted on last year. Proponents believe the matrix allows shareholders to assess the board as a whole. Those against the matrix believe it fosters a check the box approach when reviewing board candidates that might not necessarily lead to appointing the best candidate. Average support in 2019 was just 6%.

Three proposals requesting companies adopt a policy on board diversity went to a vote and two proposals received over 64% of the votes cast. The proposal that failed was put up at a controlled company and received 13% of the shares voted. **SKECHERS USA, Inc. (SKX)**, was targeted by proponents requesting a report on plans to increase board diversity as it relates to gender, race, ethnicity and sexual orientation. At the time the proposal was submitted, the board of **SKX** was comprised of all males. The proposal received 26% of the votes cast and they have since nominated a female director to the board. We expect proponents will continue to target companies with no female representation at the board level.

Average support for proposals calling for employment diversity reports has steadily increased from 32% in 2017 to 45% in 2019. This year, proposals at **Newell Brands, Inc. (NWL)** and **The Travelers Companies, Inc. (TRV)** received a majority of the votes cast.

## THE OPIOID CRISIS

The opioid crisis continues to be a hot topic of discussion though it hasn't translated to a high volume of proposals just yet. Proposals calling for reports on governance measures to manage financial and reputational risks related to the opioid crisis passed at both **Mallinckrodt plc (MNK)** and **Walgreens Boots Alliance, Inc. (WBA)** with average support of 60%. In 2018, the proposal was voted on and approved by shareholders of **Assertio Therapeutics, Inc. (ASRT)** and **Rite Aid Corp. (RAD)**, with each receiving approximately 60% approval. It is important to note the lone case where the proposal failed, was **AmerisourceBergen Corp. (ABC)**, where insider shares held by Walgreens Boots Alliance, Inc. account for 27% of the outstanding shares.

## EXEMPT SOLICITATIONS

There has been an increase in the last few years of shareholder proponents (or simply supporters of a particular shareholder proposal) filing exempt solicitation letters with the SEC. Exempt solicitations are generally a letter filed with the SEC in support of a specific shareholder proposal and urging other holders to support the proposal. While the practice of filing these exempt solicitations is becoming more common, we have not seen much of an impact on the voting results.

The filer doesn't file a proxy card in competition with the issuer's card, so they are not asking for the shareholder to send them their vote, they are asking shareholders to utilize the company's proxy card and support the proposal.

The letters are usually not mailed to holders, though there have been instances where these letters are provided to the brokers for distribution to the beneficial owners. The letter is generally picked up by the institutional shareholders once it is filed on EDGAR but most retail holders aren't aware of the filing. This is a cheap way for the activists to make sure their thoughts get out to a large number of shares without costing them much out of pocket.

We would expect this practice to continue to increase in the future.

## LOOKING AHEAD

There are several considerations to keep in mind when facing a shareholder proposal. Depending on the proposal, there is the potential to omit the proposal either through no-action relief from the SEC or negotiations with the proponent. Certain proponents have been more open to dialogue in the past few years, particularly regarding environmental and social proposals. E&S proposals typically request more reporting and disclosure while governance proposals tend to be more policy-driven, leaving little room for negotiation. Barring an omission or withdrawal, thoughtful disclosure in the proxy statement is essential and will serve as the basis for your talking points when engaging with institutional investors.

# Director Issues: Overboarding and Board Diversity

Each proxy season brings new challenges for corporate directors. Gone are the days of the "old boys club" and the rubber stamp for director elections. Investors expect their board representatives to have certain qualifications and for the Board as a whole, to have a certain composition, and those qualification and composition expectations are constantly evolving. This article explores two of the issues that Boards had to contend with in 2019, because they were brought under significantly increased scrutiny: director overboarding and gender diversity.

## DIRECTOR OVERBOARDING

Over the past few years, the issue of director "overboarding" has become a topic of much debate. Proponents of limiting director board service argue that the time commitment necessary for executing proper oversight of management is growing exponentially. The 2015-2016 NACD Public Company Governance Survey found that directors spent an average of 248.2 hours on board-related matters over the course of 2015 – a 30% increase from the 191 hours spent in 2005. Having too many commitments could limit the amount of time a director can devote to each role, which takes away from a director's effectiveness – especially during times of crisis. Others argue that the numerical limits proposed by institutional investors and proxy advisory services are arbitrary, and what matters most is the value a director adds to the board. Since individual directors have different talents and time-management skills, taking a one-size-fits-all approach to this issue runs the risk of removing valuable voices from the board room.

In an uncharacteristic move, on April 1st, with the 2019 proxy season already in full swing, The Vanguard Group released its updated proxy voting guidelines which state that its funds "will vote against any director who is a named executive officer (NEO) and sits on more than one outside public board" or "any director who serves on five or more public company boards." While Vanguard has made comments in the past about taking action against "unengaged" directors, this marked the first time the firm offered up an official policy regarding what constitutes an overboarded director.

From a corporate issuer perspective, the timing of Vanguard's policy disclosure was frustrating to say the least, but the policy itself is not unprecedented. Leading proxy advisory firms and other large institutional asset managers have already weighed in on the issue with policies of their own. The numerical limits vary from firm to firm, but the policies share the same general format - total allowable directorships are capped for non-executive directors and further restrictions are placed on public company CEOs (or NEOs, in some cases). BlackRock, for example, will allow a non-executive director to serve on up to four total boards while a CEO is allowed just two. State Street Global Advisors allows non-executives up to six total board seats while CEOs are allowed no more than three. The two largest proxy advisory firms, Institutional Shareholder Services (ISS) and Glass Lewis, will both generally recommend a vote against non-executive directors who sit on more than five public company boards. ISS will allow up to three board commitments for directors that also serve as public company CEOs. Glass Lewis limits CEOs to two boards but, like Vanguard, their policy extends to NEOs, as well. Both advisory firms state that they will not recommend a vote against an overboarded director at the company where they serve as an executive.

## TOTAL ALLOWABLE DIRECTORSHIPS

| INSTITUTION, ADVISORY FIRM | DIRECTOR TYPE | | |
|---|---|---|---|
| | INDEPENDENT | CEO (including own board) | NEO (non-CEO) |
| **ISS** | 5 | 3 | 5 |
| **Glass Lewis** | 5 | 2 | 2 |
| **Vanguard** | 4 | 2 | 2 |
| **BlackRock** | 4 | 2 | 4 |
| **SSgA** | 6 | 3 | 6 |
| **Invesco** | 6 | 3 | 6 |
| **J.P. Morgan** | 4 | 3 | 4 |
| **BNY Mellon** | 6 | 3 | 6 |
| **Northern Trust** | 4 | 2 | 4 |

Absent a compelling rationale for a director's continued board service, the against recommendations and against votes will continue in subsequent years until an overboarded director returns to compliance with the aforementioned guidelines. The presence of an overboarded director on the board will not in and of itself result in recommendations/votes against the Nominating Committee members, but that could change if the overboarded director receives significant opposition to their election. Both ISS and Glass Lewis have policies that may hold members of the Nominating Committee accountable if, in the previous year, an overboarded director receives support from less than 50% of shares voted and the situation is not sufficiently addressed.

## GENDER DIVERSITY

Another issue impacting corporate boards in 2019 is gender diversity. Workplace diversity has been one of the major societal trends in recent years. Research has demonstrated that diverse groups of people tend to make better business decisions than do homogeneous groups[1]. Further, a 2016 study by the Credit Suisse Research Institute found "clear evidence that companies with a higher participation of women in decision-making roles continue to generate higher returns on equity, while running more conservative balance sheets."[2] In response to this mounting research, corporations have made concerted efforts to increase gender diversity at all organizational levels, and the boardroom is no exception. According to State Street Global Advisors, since 2017, over 300 public companies have added a female board director and over 25 additional companies have pledged to follow suit.

Efforts to increase board diversity are also taking place in other countries. An increasing number of European countries (including Germany, France, Italy and the Netherlands) have taken measures to promote diversity by enforcing specific quotas, with penalties for companies who fail to reach diversity requirements. At this time, diversity quotas have not been enforced nationally across the U.S. However, in September of 2018, the state of California passed a law requiring California-based companies listed on major U.S. stock exchanges to be represented by at least one female board member by the end of 2019 and, depending on board size, two or three by the end of 2021. Other states are following suit, with lawmakers in New

1. Eric Larson "New Research: Diversity + Inclusion = Better Decision Making At Work" Forbes September 21, 2017
2. Credit Suisse Research Institute "The CS Gender 3000:The Reward for Change" September 2016


Jersey and Illinois announcing that they are currently working to introduce similar legislation. Federal lawmakers have introduced bills in both houses of Congress, namely the Improving Corporate Governance Through Diversity Act of 2019 and the Gender Diversity in Corporate Leadership Act, that would require companies to disclose in the annual proxy statement certain racial and gender composition data as well as corporate strategy for promoting comprehensive diversity.

Investors and advisory firms have been utilizing the proxy process to put pressure on companies, as well. Both ISS and Glass Lewis have stated that, for Russell 3000 companies, they will vote against the nominating committee chair (or other directors on a case-by-case basis) of boards that do not have any female representation. Glass Lewis' policy is already in effect for 2019, while ISS' will become effective for meetings that occur on or after February 1, 2020. Some leeway may be given to companies in certain cases, such as when a company has disclosed a commitment to appoint a female director or has provided adequate reasoning as to why there are no current female board members.

Large asset managers such as BlackRock, Vanguard and State Street have made diversity in the boardroom a major focal point during engagement with issuers. State Street has stated that, starting in 2020, they will vote against the entire nominating committee at companies that have no women on their board. Other institutional investors have cited board diversity as an important goal, but most have stopped short of offering up actual numbers or quotas in their voting policies. Vanguard, for instance, says that they will "remain vocal advocates for the importance of diversity in the boardroom," but their guidelines do not specify what constitutes a diverse board or what actions they may take against boards they believe lack diversity. BlackRock's guidelines are similarly vague but do divulge potential consequences, stating "to the extent that we believe that a company has not adequately accounted for diversity in its board composition within a reasonable timeframe, we may vote against the nominating / governance committee for an apparent lack of commitment to board effectiveness." JP Morgan Asset Management is one of the few that offer a specific target. Their guidelines state that "although (they) do not endorse quotas," they "generally support the target of one-third of board positions being held by women."

## CONCLUSION

As overboarding and gender diversity have recently come under additional scrutiny, issuers must focus on and manage the overall composition of the board. In the future, we generally expect most firms to take a holistic view of diversity that takes into account factors such as experience, skills, and background in addition to race, ethnicity, tenure, and gender. While "best practices" have yet to be defined, you can be sure that the push for comprehensive diversity will continue to gain momentum. Similarly, the definition of an overboarded director continues to evolve, as well. In addition to the policy changes of some prominent institutional investors, ISS recently released its Benchmark Policy Survey asking institutional investors for their views on allowable number of directorships. Issuers should be proactive in crafting a strategy to address board diversity and be prepared to discuss the current board composition as well as near and long-term plans for board refreshment.

# Say-on-Pay 2019 Proxy Season

After ten years of Say-on-Pay voting, the topic of executive compensation continues to be in the spotlight. Overall, and similar to past years, most companies receive relatively high support on Say-on-Pay proposals, as the average affirmative vote for Russell 3000 companies exceeds 90% of the shares voted thus far in 2019. This can be attributed to the fact that many companies work hard in the off-season -- engaging with their shareholders on compensation issues, processing the feedback received and working with their compensation consultants and other advisors to provide the Compensation Committee with the information necessary to make informed decisions in order to create a compensation program which links executive pay with the long-term strategy of the company.

Say-on-Pay is very much a company specific issue, more so than most other proposals, and companies need to make sure they are monitoring their compensation programs and engaging with their investors to ensure they are managing their risk appropriately when it comes to the Say-on-Pay vote.

Not surprisingly, advisory firms continue to change their methodology as it relates to Say-on-Pay, by updating their voting policies and pay-for-performance tests on a regular basis. Specifically, ISS' Quantitative Pay-for-Performance Test was updated in the beginning of 2018 to screen the long-term alignment between CEO pay and key financial metrics. This was updated to ensure the following metrics were incorporated; company's CEO pay and total shareholder returns as compared with similar comparison groups, CEO pay as compared with median CEO pay of its comparison groups, trends of the CEO's annual pay with the value of the company's investment, and the percentile ranks of the company's CEO pay compared with the financial performance of the company. For 2019, ISS started to phase in the inclusion of Economic Value Added (EVA) data to their reports, simply for informational purposes this year, but ISS is exploring how it might utilize that EVA data in future pay-for-performance evaluations.

Now more than ever, institutional shareholders are dissecting the nuances of company compensation programs, as many have ramped up the methodology they use in evaluating executive pay. This has led to increased pressure on issuers to develop a cohesive narrative that demonstrates how the basic construct of the compensation program as well as the compensation committee decisions (i.e., metrics and targets, mix of time-based and performance-based awards, etc.) align with the overall long-term strategy of the company and avoid the types of "poor pay practices" that undercut this connection.

## MANAGING THE SAY-ON-PAY VOTE

Investor outreach and compensation disclosures have grown significantly over the years and are key to improving Say-on-Pay votes and minimizing the risk of an against recommendation or vote. Many companies have recognized that compensation disclosures in proxy statements are among their most important investor communication tools, as it allows the company a chance to tell their story about the Board's compensation decisions and explain how their compensation programs support long-term growth. As a supplement to compensation disclosures in the proxy, many companies have implemented off-season outreach programs to shareholders, through which governance and investor relations teams, in conjunction with their legal, human resources and sustainability colleagues, collaborate to communicate a much more substantive story to their shareholders. The feedback received from these conversations with shareholders is critical, as it can lead to a better understanding of how pay practices are viewed by investors, as well as help in the development of a more effective compensation program in subsequent years.


Pay-for-performance is often the first screen the advisory firms or individual institutions use in deciding how closely to review a company's entire compensation program. Other than flagrantly poor compensation practices, institutions and advisory firms may not scrutinize certain pay practices as closely if the company's pay-for-performance is viewed as being in alignment. However, in a year where pay-for-performance is seen as being out of alignment and the advisory firms and investors take a closer look at the details of the compensation program, the same practices that were ignored or not closely scrutinized in a year of sound pay-for-performance may now be the reason for an against recommendation or vote, even though no changes were made to the company's compensation program.

Beyond pay-for-performance issues, adopting certain compensation practices known for raising investor concerns leads to challenging conversations between companies and their investors. They also potentially lead to increased opposition to executive compensation programs. Some common problematic pay practices include:

- Contractual payments, particularly guaranteed over multiple years
- Discretionary/excessive bonus payments, equity awards, and one-time awards
- Misaligned pay compared to peer group
- Low performance targets

Additionally, certain practices are viewed by ISS (and institutional investors) as rising to the level of not just a vote against Say-on-Pay, but also votes against the compensation committee members up for election. These practices are listed below:

- The board's failure to respond to a Say-on-Pay proposal that received less than 70% approval the year before
- Repricing options/stock appreciation rights without shareholder approval
- New or material amended change in control agreements that contain single (or modified single) triggers or allow for excise tax gross-ups

## ACTION PLAN

### 1. SHAREHOLDER ENGAGEMENT

Maintain solid relationships with investors by conducting off-season outreach to the governance personnel at institutional holders to understand their concerns and update investors on the company's business and any changes in governance or compensation programs. This outreach will give the company constructive feedback about its compensation and governance programs. We have seen the benefit of this dialogue many times when companies are faced with against recommendations from the advisory firms.

### 2. ANALYZE

Review the Say-on-Pay vote from your last annual meeting and take note of any comments made in the advisory firm reports or any comments received from investors. Determine if any changes to the program need to be made or at least discussed prior to the next annual meeting. Understand if there is the potential for opposition at the next meeting. If changes are made to the compensation program, make sure you understand how those changes may be viewed by your investor base.

### 3. DISCLOSE

Prepare well written proxy disclosure detailing: i) proactive shareholder outreach, ii) changes made to the compensation program, if any, iii) how the compensation program is aligned with the company's long-term strategy and how it will create value for shareholders. The proxy statement should tell the company's story and explain any decisions made since the last annual meeting.

## CONCLUSION

The average favorable vote on Say-on-Pay remains very high, this is not a reason for companies to be over confident. Each year the advisory firms update their methodology and more institutions develop their own internal policies for voting on Say-on-Pay. Companies need to be alert to the policy changes and plan accordingly.

It is more important than ever to maintain a robust outreach program with your key institutional investors and to use your proxy statement as a tool to tell the company's compensation story. Through these initiatives, companies are able to communicate changes to their compensation program and demonstrate how the program supports the company's long-term strategy as well as efforts to further improve the long-term performance of the company. We have seen the payoff from these actions time and again when companies are faced with negative recommendations from the advisory firms or when they have to take action in the face of a failed Say-on-Pay vote.

# Short interest and shares on loan

## Index Funds may represent 30-40% or more of your investor base, but don't count on them to vote all their shares.

We have all heard of short selling. Generally, traders and investors can make a bet that a stock price may decline by borrowing and selling a stock with the hopes of buying it back at a lower price in the future. This is one of many short selling scenarios, but there are other reasons why investors may short a stock - including several different types of hedging strategies such as convertible arbitrage or market-neutral techniques. In addition, brokers and market-makers may short in order to provide required trading liquidity in the capital markets.

In order for short selling to take place, investors such as large index funds loan shares as part of the behind-the-scenes mechanical process. Securities lending is a well-established practice whereby U.S. registered funds, such as mutual funds or ETFs, make loans of securities to seek an incremental increase in returns for their fund shareholders. In fact, securities lending is a vital component of the financial markets. As of December 31, 2018, more than $19 trillion of assets were available for lending globally, with more than $1.7 trillion on loan. Securities lending increases market liquidity, and in doing so, facilitates transactions, helps to mitigate price volatility, and reduces transaction costs. Some have criticized securities lending as a risk to market stability; however, the Federal Reserve has found that short sales can actually improve market stability[1]. Its research has shown that short selling does not systematically drive down asset prices, and that restricting short selling can actually lead to reduced liquidity and higher transaction costs for investors as securities lending and short sales help to improve liquidity and enable investors to hedge risk.

Another circumstance to consider is how security ownership shifts could occur when certain investors take part in a dividend swap, whereby the purchaser of the swap agrees to pay a fixed dividend payment amount in exchange for the sum of all qualifying dividends during the period of the swap. Pension fund investors have used dividend swaps as a capital efficient means for income exposures without requiring full cash upfront.

### GOVERNMENT REGULATION

The "uptick rule" in the United States was originally implemented by the SEC in 1938, which required every short sale transaction to be entered into at a price that was higher than the previous traded price, or on an uptick. The rule was designed to prevent short sellers from compounding downward pressure in a stock as it is already declining. The uptick rule was repealed in July 2007 and in 2010, the SEC adopted an "alternative uptick rule" that restricts short selling when a stock has dropped at least 10% in one day. Regulation SHO was implemented in 2005, which was designed to curb "naked" short selling (when the seller does not borrow or arrange to borrow the shorted security).

There has been increased talk in Washington recently on corporate visibility into short sellers, but there currently are no mandated public filings in the U.S. that would require disclosure of exactly who is shorting an issuer's stock. Generally, most companies rely on short interest data, which is released bi-monthly by the exchanges. This information is a helpful gauge, but it is important to note that these figures are only a snapshot that can vary significantly between data releases, especially if there is a sharp increase in trading volume.

1. Source: Federal Reserve Bank of New York Staff Report no. 518, "Market Declines: Is Banning Short Selling the Solution?" September 2011.

## WHAT COMPANIES CAN DO

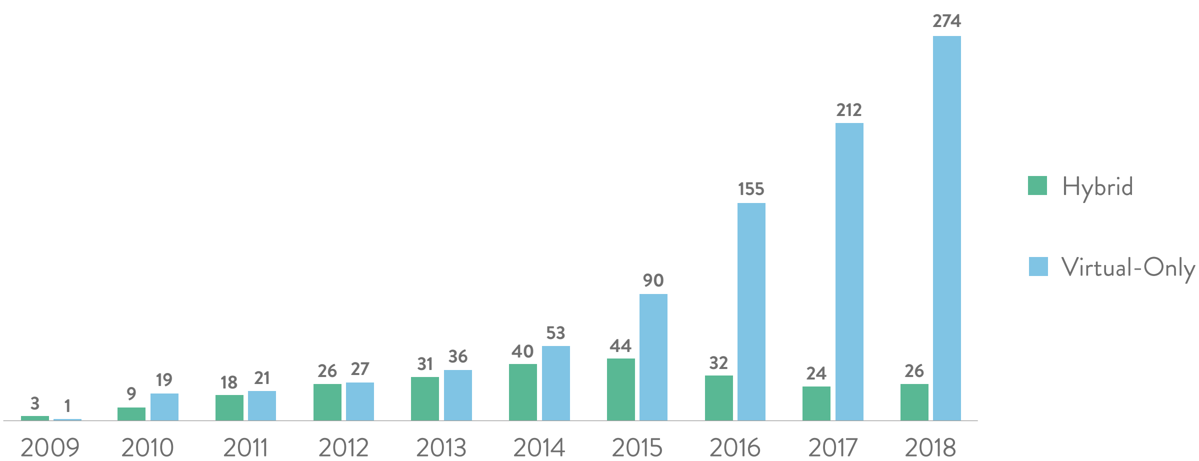
Companies need to have a clear picture of their shareholder base, and as such, should monitor investor changes year-round. It is particularly important to understand the record date voting authority for all investors in preparation for the annual meeting. Short selling and the associated security lending can have a major impact on vote returns, a fact many companies do not realize until it is too late. For example, the publicly available 13F filings for a corporation may indicate a large index fund is the company's largest shareholder, representing 10% of the outstanding shares. While some may assume this investor has full voting authority over all of these shares, that very well may not be the case. Consider if the large index fund lent half of its position to short sellers – this would have a significant impact on the vote. Another concern arises around contested situations where activist investors may borrow shares before the record date for the express purpose of obtaining proxy votes.

Double reporting may also occur in the 13F filings, as the institutions that lend shares and those that purchase shares (from the borrower) may file for the same block of shares. Fund managers can recall shares on loan for voting purposes or other reasons, but that option is often weighed against revenue from continued securities lending. Regulatory disclosures suggest asset managers often choose the money. In light of these complex issues, companies should monitor their short interest and shares that may be on loan throughout the year. As the annual meeting approaches, they should assess their ownership profile taking into account the voting authority as of the record date for the shareholders meeting.

# Virtual shareholder meetings

Since the inception of virtual shareholder meetings in 2009, we have seen a substantial increase in the number of companies availing themselves of this approach, from 4 virtual meetings in 2009 to 300 in 2018. Of those 300, 274 were virtual-only shareholder meetings, with the remainder being hybrid meetings where the company still conducts an in-person meeting with a virtual component. We do not yet have final numbers on the 2019 Proxy Season, but indications are that the numbers will surpass 2018 by a fair margin.

## THE INCREASE OF HYBRID AND VIRTUAL-ONLY SHAREHOLDER MEETINGS FROM 2009-2018




Source: Broadridge Financial Solutions

In 2000, Delaware amended its General Corporation Law to allow electronic meetings and other states soon followed suit. Today, 30 states allow virtual-only meetings and another 12 states allow hybrid meetings. Currently, nine states (Alabama, Alaska, Arkansas, Georgia, Idaho, New Mexico, New York, South Carolina, South Dakota) require an in-person meeting and those states prohibit companies from holding a virtual meeting. Of note, General Motors (GM) and American Airlines Group (AAL) decided to hold a virtual-only shareholder meeting for the first time in 2019. Other large companies that have held virtual only meetings over the last few years and continue to do so are: Lululemon Athletica Inc. (LULU), Netflix Inc. (NFLX), Hewlett Packard Enterprise Company (HPE) and Intel Corp. (INTC).

The virtual shareholder meeting has some major differences and some similarities to traditional physical shareholder meetings. A company provides a URL to its shareholders to go to the virtual meeting website. Shareholders then have to enter a control number, which they will have received in the material that was mailed to them. If they do not have one, they will have to reach out to their brokerage firm and request one. Once in the virtual meeting, shareholders would be able to ask questions as well as cast their votes online while the meeting is in progress. The company will then be able to monitor, in real-time, how many shareholders have attended the meeting and how many shares are being voted during the meeting.

Starting with the 2019 proxy season, Glass Lewis announced that it would generally recommend voting against governance committee members where the board plans to hold a virtual-only shareholder meeting and does not provide adequate disclosures that guarantee shareholders the same rights and opportunities to participate in the meeting as they would at a physical shareholder annual meeting.

The following are examples from Glass Lewis of "effective disclosures" about shareholder participation rights at a virtual-only shareholder meeting:

- Addressing the ability of shareholders to ask questions during the meeting, including time guidelines for shareholder questions, rules around what types of questions are allowed, and rules for how questions and comments will be recognized and disclosed to meeting participants;

- Procedures, if any, for posting appropriate questions received during the meeting, and the company's answers, on the investor page of the company's website as soon as practical after the meeting;

- Addressing technical and logistical issues related to accessing the virtual meeting platform; and

- Procedures for accessing technical support to assist in the event of any difficulties accessing the virtual meeting.

Glass Lewis also states that companies that determine to hold virtual-only shareholder meetings should review their meeting processes and consider including detailed disclosures in their proxy statement about how shareholders will be able to participate in the meeting.

In general, we believe Glass Lewis' view is in-line with the majority of investors regarding virtual-only shareholder meeting. Most investors expect any company that holds a virtual-only shareholder meeting to offer the shareholders the same rights they would have as if they were attending the shareholders meeting in-person.

To date, ISS has not adopted a formal policy on virtual-only shareholder meetings in the U.S.

Both ISS and Glass Lewis update their policies late in the year, and we will make you aware of any significant updates to their policy regarding virtual shareholder meetings.

In addition, some companies are getting pushback from certain investors, but the practice of holding virtual shareholder meetings has been widely accepted by the investor community. There have been several shareholder proposals submitted to restore an in-person annual meeting by activists but so far the SEC has issued "no action letters" on these proposals since they believe the proposal falls under the "ordinary business" exclusion.

Below are some factors to consider before deciding if a virtual meeting is right for your company:

- How many shareholders generally attend your in-person annual meeting?
- What benefits does the company realize by having shareholders attend their meeting in person?
- What are the differences in cost for the three options: Virtual Only, Hybrid or in-person only?
    - For many small cap companies an in-person meeting may be less expensive depending on the turnout or location (e.g. company conference room) of the meeting.
- Know your shareholder base:
    - Knowing your shareholder base may help prepare the company for any opposition it may receive from certain investors.
- What proposals do you have on the agenda?
    - Do you have any contentious proposals on the agenda or does the company have governance issues that shareholders are concerned about?

In 2012, a study group, co-chaired by Darla Stuckey, president of the Society for Corporate Governance, and Anne Sheehan who was the former director of corporate governance at CalSTRS, was put together to discuss the "Guidelines for Protecting and Enhancing Online Shareholder Participation in Annual Meetings". In 2018, a majority of the same study group reassembled to discuss Virtual Annual Shareowner Meetings. The group is comprised of retail and institutional investors, public company representatives, and proxy and legal service providers. The Group's purpose was to discuss best practices and principles for virtual shareholder meetings.

## THE STUDY GROUP CAME UP WITH THE FOLLOWING BEST PRACTICES AND PRINCIPLES:

- Determine the meeting format before publishing the proxy statement
- When considering the format of the annual meeting, the company should consider the items to be voted at the meeting (i.e. controversial management or shareholder proposals, etc.)
- Evaluate constantly changing technology and process
- Ensure equal access all shareowners
- Create formal rules of conduct
- Establish reasonable time guidelines for shareowner questions
- Establish rules for when questions are out of order
- Establish rules to promote transparency
- Post questions received online during the meeting
- Ensure shareowners have access to board members
- Have a technical support line available
- Archive virtual shareholder meetings for future viewing.

Source: Broadridge Financial Solutions

As we noted, the number of virtual meetings continues to increase and while there has been some investor opposition, investors have generally been accepting of virtual meetings so long as the platform affords shareholders the same rights and abilities as an in-person meeting. There is not a one-size-fits-all approach in deciding whether to move to a virtual meeting; some boards prefer to have in-person meetings to allow them to meet shareholders face to face and others may want to show that they are on the cutting edge of technology. Whatever the case, if an issuer is thinking about moving to a virtual meeting, we suggest taking the factors listed above into consideration before making your final decision.

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