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Compliance & Ethics PROFESSIONAL®

A PUBLICATION OF THE SOCIETY OF CORPORATE COMPLIANCE AND ETHICS

SEPTEMBER 2018



**Meet
Ibrahim Yeku, CCEP-I**

Barrister & Solicitor
Solola & Akpana
Old GRA, Port Harcourt,
Nigeria

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Five takeaways from the 2018 proxy season

- » The disclosure of CEO pay ratios, as mandated by Dodd-Frank, has not had a major impact on the investing public.
- » Public companies have used new interpretations of Securities and Exchange Commission rules to exclude shareholder proposals from consideration.
- » Shareholders used environmental, social, and governance proposals to spotlight new risks, like cybersecurity and opioids.
- » Social issues sparked multiple “withhold the vote” campaigns.
- » Proxy season documents have become storytelling opportunities.

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Numbers don't lie, as the saying goes. But they don't tell the whole story, either.

Now that we have some perspective on this year's proxy season, that may be the clearest theme to emerge from it. The concerns of proxy season have always been larger than the numeric obsessions of earnings season: revenues, accounts receivable, earnings per share, adjusted earnings per share, and so on. But increasingly, proxy season has become a moment for investors to test—and management to prove—a corporation's values.

This year, the signs of that trend were unmistakable. Back in January, BlackRock founder Larry Fink sent a very public message to CEOs that his institution's level of interest in their businesses would depend on their own interest in social responsibility. His letter stated:

To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society. Companies must benefit all of their stakeholders, including shareholders, employees, customers, and the communities in which they operate.

A month later, BlackRock issued a set of proxy voting guidelines that emphasized the environmental, social, and corporate governance issues that have come to dominate proxy season. It appears to have backed those guidelines up with votes. When faith-based investors pushed gunmaker Sturm, Ruger & Co. to report on the risks of its business, BlackRock voted its 2.8 million shares in favor of the successful proposal. Viewing the trend more broadly, data from Intelligize indicates just how sharply discussion of environmental, social, and governance (ESG) issues has risen in public company filings and earnings calls. From 2017 to 2018, mentions of ESG topics



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increased 38% in 10K forms, 98% in proxy communications, and a dramatic 123% in earnings call transcripts—potentially reflecting particularly intense interest in ESG issues from analysts.

Certainly, bottom-line numbers will always remain of prime importance to investors. As usual, there's no shortage of hot topics revolving around them—from tax impacts to revenue recognition. But in 2018, investors seem to believe there are deeper drivers of success. They seem to believe that an issuer's reactions to the opioid crisis or the #MeToo movement, for instance, are telling of its character in ways that investors of previous decades would not have considered.

And they seem to believe—as demonstrated in the takeaways below—that numbers don't tell the whole story.

CEO pay ratios aren't front-page news

This proxy season, one of the ticking time bombs in the Dodd-Frank reform legislation finally detonated. For the first time, issuers were required to disclose the ratio between their CEO's annual pay and that of their median employee. Theoretically, the disclosures will spotlight cases in which executive pay is excessively lavish or disproportionate to performance. But this bomb has not proven terribly explosive.

As expected, the numbers were high. The first issuer out of the gate, Honeywell, reported a 333 to 1 ratio (CEO Darius Adamczyk made \$16.8 million, compared to the median employee's \$50,296). That fell generally in line with past studies that put the average CEO-to-worker ratio in the 300 to 1 neighborhood. Others came in still higher. The ratio for Yum! Brands reached 1,358:1. For Gap, it was 2,900:1. And Weight Watchers International tipped the scales at 5,908:1.

Although research indicates that people disapprove of such gross disparities, the ratios have not stirred great ire among investors.

Nor have they sparked protest among the one audience issuers were most concerned about: their employees. (Wells Fargo, a notable exception, faced backlash over its 291:1 ratio.) Pay-ratio stories have failed to gain traction because informed stakeholders understand how little the numbers mean. Last September, the Securities and Exchange Commission (SEC) gave issuers wide latitude in deriving their ratios, permitting any calculation based on reasonable estimates, assumptions, or methodologies. For this and other reasons, critics like the Center on Executive Compensation have argued that the ratios do not provide informative comparisons between companies.

No one believes that pay ratios close to 1:1 for private equity firms Apollo Global Management or Carlyle LP reflect any degree of income equality between their CEOs and median employees. (The pay ratios don't reflect eight- and nine-figure company dividends paid to the executives.) The 59:1 ratio for Amazon's Jeff Bezos is similarly deceiving, given that his stock holdings increased by more than \$30 billion last year. Even the gulf between Mattel Inc.'s 4,987:1 ratio and Hasbro's 160:1 ratio is difficult to judge, given factors like Mattel's reliance on seasonal workers, which drove down its median employee pay to less than \$6,500.

Corporations strike back on shareholder proposals

In 2017, activist shareholders found surprising success with ESG-related proposals, including shocking wins on management-opposed climate-change proposals at ExxonMobil and other companies. It felt like a tipping point...until the SEC rebalanced the scales. Late last year, the SEC quietly updated its guidance on shareholder proposals. Acquiescing to demands by business groups, the agency revisited its interpretation of two rules that issuers can

cite to avoid putting proposals to a vote. One requires that the proposal be “economically relevant” to the business, and the other gives management exclusive domain over “ordinary business problems.” In both instances, the SEC’s updated readings favored management.

This year, management wielded its new authority with some success. At least five different times, the SEC endorsed issuers’ refusal to put proposals up for a vote. Dunkin’ Brands Group (the holding company for Dunkin’ Donuts and Baskin-Robbins), for instance, successfully used the “economic relevance” rule to reject a proposal that would have required the board to “assess the environmental impact of the company’s use of K-Cup Pods packaging.”

Shareholders ask about emerging risks: Cyber and opioids

As shareholders continue to get more aggressive about pushing social and environmental agendas with public companies, they are introducing proposals that spotlight new risks.

This year, cybersecurity and opioids became a focus of several proposals. Following last year’s disastrous breach at Equifax, the UAW Retiree Medical Benefits Trust asked Equifax for a report on:

the governance measures Equifax has implemented to more effectively monitor and manage financial and reputational risks related to cybersecurity incidents that have a material effect on the company, including whether Equifax has revised senior executive compensation metrics or policies...

The UAW isn’t alone in looking to hit executives in their wallets over cyber preparedness. A New York state retirement fund submitted a proposal asking Verizon, which recently purchased the infamously breached Yahoo!, to tie the compensation of senior executives to the company’s performance on cyber security. In terms of new proposals, the most interesting may be 21 proposals filed by Investors for Opioid Accountability, asking opioid manufacturers and distributors to comment on opioid-related business risks.

The Verizon compensation proposal failed to win over a majority of voters, as did the opioid proposal with AmerisourceBergen, one of the country’s largest pharmaceutical wholesalers. But that does not mean the proposals

didn’t resonate. Excluding the votes of insiders like Walgreens pharmacy, which owns 26% of AmerisourceBergen, the opioid proposal won more than 60% of the shareholder vote.

Withhold-the-vote campaigns

Issues of social responsibility and ethics also drove a number of withhold-the-vote campaigns this season. Such campaigns signal the disapproval of individual board members (or entire slates), and this year they arose from hot-button social issues. At Wynn Resorts, the ex-wife of Steve Wynn—who resigned after his years of predatory behavior toward women came to light—engineered a withhold-the-vote campaign that resulted in sweeping changes. Elaine Wynn, the company’s largest shareholder, initiated the campaign to express frustration at the board’s lax supervision of her former husband. She aimed it at one board member in particular, John Hagenbuch,

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who is personally close with Steve Wynn and who accepted an appointment on a committee reviewing his conduct. Glass Lewis supported the campaign. Two days before the shareholder meeting, Hagenbuch withdrew his name for reelection, and a second director resigned from the board. In April, Wynn Resorts named three new directors—all female.

Meanwhile, activists conducted a less successful withhold-the-vote campaign against a board member of gun maker Sturm, Ruger & Co. over her ties to the NRA (she served as NRA president from 2005–2007). BlackRock voted its shares for that director but, as noted, also voted for the proposal requiring a report on risks of the firearms business, which earned 7.2 million votes for and just 3.3 million votes against.

Storytelling in proxy materials

A final trend is a change in proxy season documents themselves. With investors keenly attuned to potentially volatile issues like pay and gender equity, proxy season mailings are no longer the utilitarian documents that they were in the recent past, circulated to check one more box on a list of regulatory compliance measures. The reputational stakes associated with the document are much higher, as investors scour them for clues regarding a company's performance and commitment to certain values. Accordingly, the proxy mailing has become a useful opportunity for issuers to showcase their culture, to defend against activist measures, and to tell their story to the market. The website of law firm Shearman & Sterling, for instance, asks issuers to "consider whether you are effectively telling your 'compensation story.'"

It's wise advice—a recognition that persuasive framing can have an enormous impact on how investors understand the numbers in a proxy document. But as the above takeaways suggest, numbers are hardly

the only thing investors care about. More and more, proxy season is a time in which a company's values come under the microscope. The focus on ESG issues has continued to intensify, despite the newly broadened authority that issuers have to exclude certain shareholder proposals, and despite the potentially distracting impact of less-than-informative CEO pay ratios. In the latter instance, the investing public seems to have demonstrated an ability to focus on substance over superficial numbers.

Meanwhile, it seems clear that the diversity of ESG issues of concern to investors is broadening. Today, it is opioids and cybersecurity; by next year, certainly, shareholders will have caught up to the latest environmental and social issues—whether they be restaurants' use of plastic straws or the amount of time children spend occupied by screens. For C-suites and their investor relations departments, the implication is that proving their values on ESG issues will be an ongoing, evolving project, not something that gets performed once and checked off a box. The avenues through which ESG-related matters are finding expression are also multiplying. In addition to shareholder proposals, this year we saw a proliferation of withhold-the-vote campaigns, at least one of which drove substantial change. Given the passions around ESG topics, we can only expect that activists looking to change corporate behavior will continue to find new opportunities to bring them to the fore.

Going forward, companies that want a harmonious relationship with their shareholders will have to do more than present satisfying numbers. In today's world, they tell only part of the story. Instead, issuers must enter proxy season with a narrative about their company values as well. Their ability to articulate those narratives, and live up to them, are proxy season's most important new metric. *