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Preparing for Proxy Season 2018: A Primer for General Counsel

As we enter 2018, public companies across the United States will begin, in earnest, their preparations for this year's proxy season and annual shareholder meetings. It is not an understatement to say that 2017 was a tumultuous year on many fronts — economically, politically and globally. As a result, general counsel should have several issues on their radar that could play a role in 2018's proxy season.

By Phil Brown

As we enter 2018, public companies across the United States will begin, in earnest, their preparations for this year's proxy season and annual shareholder meetings. It is not an understatement to say that 2017 was a tumultuous year on many fronts — economically, politically and globally. As a result, general counsel should have several issues on their radar that could play a role in 2018's proxy season.

CEO Pay Ratio Disclosure

For GCs, the prospect of disclosing their company's CEO pay ratio — that is, the ratio between the CEO's compensation and their median employee pay — was likely chief among the issues that kept them up at night over the holiday season. Even with the Trump administration's stated goal of deregulation, the SEC made it clear in a September 2017 interpretive guidance that the pay-ratio rule will be in effect for the upcoming proxy season. Under the rule, registrants must provide the disclosure for the first fiscal year beginning on or after Jan. 1, 2017, which means that registrants will begin doing this in early 2018.

Mandated under Dodd-Frank to take effect in 2018, this disclosure has a been long time coming and should not be a surprise to GCs — though they may have hoped the twists and turns this policy has gone through would lead to its eventual demise. That is not the case, however, and it is now clearly one of the main things shareholders will be looking for in 2018 proxy statements.

Potentially Controversial, Yet Companies Remain Unprepared

There is significant evidence that the pay-ratio figures disclosed by many companies could be rather controversial, even alarming, for shareholders. A recent survey by Pearl Meyer titled "Looking Ahead to Executive Pay Practices in 2018" revealed that 40% of companies expect to report a pay ratio of between $100 and $250 for every dollar earned by their median worker. Another 20% are bracing for the revelation of an even higher ratio.

Even as they might be about to release such numbers, there seems to be a disconnect at the corporate board level on the matter. The same Pearl Meyer survey revealed that most companies (76%) had not even discussed how to communicate the ratio, either externally or internally. This oversight might be due to the fact that 79% of management and board members (but, crucially, not investors) think the ratio disclosure will be "not at all helpful" to shareholders.

GCs Must Drive Conversation on CEO Pay-Ratio Disclosure

Heading into proxy season — in light of the above — one of the first tasks for the GC of any company that doesn't see pay ratio as an issue should be to drive conversations at the corporate board level on the issue. Even if corporate boards do not see it as helpful information for investors, their shareholders will likely feel otherwise.

Arriving at 'The Number'

The SEC's September guidance that CEO pay ratio disclosure was a

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go for 2018 was unwelcome news to some. Nonetheless, the SEC did provide some potential relief for companies grappling with how to actually calculate the figure. As long as companies use reasonable means to arrive at the CEO pay-ratio number, the SEC said, it will not be second-guessed by enforcement officials; only clear evidence of bad faith will spur the agency to action. That assurance, in itself, should give GCs some reassurance as they work with the corporate board to figure out their methodology.

As to how companies should calculate their number, particularly on the thorny issue of identifying a "median employee," the SEC was also helpful. The guidance included three hypothetical examples, which described using estimates, statistical sampling and other "reasonable" ways of determining the median employee. The examples specifically look at complex situations in companies with multiple business units or operations outside the United States. GCs would be well served by reviewing those examples, as well as the rest of the SEC's interpretive guidance.

It is difficult, if not impossible, to provide one-size-fits-all advice to GCs regarding the means they should use to both identify a median employee and then calculate the CEO pay ratio. That being said, the following elements of the SEC guidance may prove particularly helpful:

- Companies may use "reasonable" internal records. The SEC has said that companies may use tax or payroll records that give a reasonable accounting of median compensation, even if they do not factor in all compensation, such as equity.
- Statistical sampling permitted. Companies may use statistical sampling to determine their median employee. In addition, they may combine sampling methods.
- The SEC will allow "reasonable" estimates. In cases where arriving at an exact number is difficult, the SEC will allow companies to make "reasonable" estimates for figures such as workforce composition, compensation distribution, and a measure for annual total compensation.

Communicating 'The Number'

Once the company has arrived at its number, decisions will have to be made about how to frame it for shareholders. A CEO pay ratio under $100 is likely ideal. Anything above that may require special considerations for both GCs and corporate boards in terms of the language used in the disclosure.

Having a number higher than $100 is also not, in and of itself, a bad thing. If a company is doing well and can demonstrate CEO compensation is not out of line for that level of performance, a figure of $150, $200 or even $250 may not be unreasonable. This is particularly the case if companies followed a careful and deliberate process for identifying their median employee and can demonstrate a progressive approach to compensation in which everyone is sharing in the success.

Of course, the sooner a company has its number, the sooner it can start making decisions about how to handle the disclosure. This is why it is so important for GCs to be driving these discussions and moving the issue forward. Not doing so is simply risking liability come proxy season.

It remains to be seen how sensitive an issue CEO pay disclosure will actually be in 2018. Even so, GCs should plan early and thoroughly regarding how that disclosure is made.

Other 2018 Proxy Season Issues

While CEO pay ratio disclosure is likely what most GCs are grappling with heading in to the 2018 proxy season, there are other issues that should also be on their radar as they make preparations.

The Trump Administration: Managing Political Risk

No discussion of 2017 would be complete without a mention of the new Trump administration. It has, after all, dominated headlines since Election Day 2016. For their part, companies will likely be bracing for questions regarding how they are taking the impact of political uncertainty into consideration as they make decisions.

For GCs guiding the response to these questions, a "less is more" approach is likely the best. They should expect shareholders, particularly activist shareholders, to raise the issue on any number of fronts. For many companies, however, this is not a time to be making bold political statements. For many GCs, the safest course will be to avoid saying anything that might antagonize either this administration or those that support it. Put plainly, the risk of becoming the target of a Presidential tweet

will be on the minds of GCs — and rightly so.

That does not mean, however, that companies can keep mum on controversial issues. Saying nothing could cause as much harm as saying too much. And, shareholders are expecting to hear what companies are doing on a variety of hot-button matters, from climate change to sexual harassment. The current political climate demands adding another layer of scrutiny when considering responses to politically charged questions. They should be prepared well in advance with an eye to consistency across the company in terms of its position on the Trump administration and its policies.

It is not an option for GCs to go into proxy season 2018 without a clear sense of how their company will address questions raised by the Trump administration. There is simply too much liability and risk.

New Accounting Rules

The new accounting rules on revenue recognition (606) and lease impairment (842) may have been overshadowed by the CEO pay-ratio issue, but they are no less important for GCs to understand. They do not take effect until 2018, but they will likely have an impact on this year's proxy season regardless.

In particular, GCs will have to make decisions about whether or not to adopt these rules for this past year, or the year going forward. That decision will affect what is included in their 10-K filing. Though this is not, strictly speaking, a proxy matter, it is a corporate issue that will nevertheless be in the background this season, regardless of whether or not companies adopt the rules for 2017 or 2018.

Cybersecurity and Data Breaches

For the past several years, the corporate world has been rocked by data breaches affecting companies across all industries. Unfortunately, 2017 was no exception. Perhaps the most memorable was Equifax, but Uber, Whole Foods, Deloitte, Verizon and many other well-known companies all disclosed data breaches this past year.

It is likely shareholders will again be asking pointed questions of companies regarding the data they collect and store, and what they do to protect it. That has certainly been the case on earnings calls throughout the year. Companies operating in industries that have had a well-publicized breach this year will likely face even more scrutiny. GCs should expect to have to outline their data protection policies and procedures this proxy season, address any new risks and liabilities, and discuss how they are keeping current as this issue evolves.

Activist Investors

Activist investors are a fact of life for any public company with shareholders. Inevitably, it is always a shareholder activist who brings up an issue or asks a question that paints the company in a negative light.

Thankfully, the actions of activist investors are often predictable. If they have behaved a certain way for one company, they will likely repeat this at another. This is particularly the case when shareholder activists are looking to place a new director on a corporate board. They will employ strategies used with other companies in the past.

GCs would be wise to prepare for this year's proxy season by examining how potential activist investors have behaved in the past, the issues that concern them, and mechanisms used to place directors on boards. Thankfully, this will likely not be a surprise. An activist investor will have already bought stock, crossed the 5% threshold or made a Williams Act filing. Who they are will be known far in advance.

It is also important to consistently monitor and enforce rules around filing deadlines, stock purchases, and related issues so an activist investor who has not followed the right procedure cannot slip through the cracks. Doing this consistently will avoid any accusations of unfair or unequal treatment.

A GC's Mantra for the 2018 Proxy Season: Prepare, Prepare, Prepare

This is not the year for GCs to skimp on preparations for proxy season. In fact, GCs should consider putting even more time into getting ready for 2018. With so many variables in play, from CEO pay ratios to political uncertainty, there may be more at risk than ever from proxy season. Shareholders will have done their homework, particularly activist investors. It behooves GCs to be similarly prepared.

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