

## PROXY ADVISOR POLICY CHANGES FOR 2015

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In early November, proxy advisors Institutional Shareholder Services (ISS) and Glass, Lewis & Co. released their voting policy updates for the 2015 proxy season.<sup>1</sup> ISS's policy changes will take effect for annual meetings on or after Feb. 1, 2015, while Glass Lewis's policy updates will apply to annual meetings on or after Jan. 1, 2015.

The most pronounced changes relate to compensation. In reviewing equity compensation plans up for approval or amendment, ISS is moving away from its current series of past/fail tests to a balanced scorecard approach that weighs the positive and negative features of the plan. Glass Lewis has also enhanced its guidelines pertaining to say-on-pay (SOP) proposals (clawback policies and one-off awards to executive officers) and to employee stock purchase plans.

Other key revisions are in direct response to some recent, controversial corporation actions: recombining the chairman/CEO roles (Bank of America and Hewlett-Packard), attaching rigorous informational and procedural requirements to special meeting rights (Allergan), and adopting adverse governance provisions without shareholder approval or prior to going public (Alibaba Group Holding).

Issuers should note that some of ISS's policy changes (litigation rights and unilaterally-adopted charter/bylaw amendments) were not included in ISS's draft policies issued for comment on Oct. 15, 2014. Others (independent chairman proposals) were not addressed in ISS's policy survey, circulated on July 17, 2014. Glass Lewis also made some refinements to its proxy

access policy, which appears in its full set of 2015 guidelines but not in its summary of changes.

This article discusses the proxy advisors' policy revisions related to governance and environmental/social issues and Alliance Advisors' view of their potential implications for issuers. We will be issuing a separate review of their policy updates on compensation in a subsequent article.

### Governance

#### *Responsiveness to Majority-Approved Shareholder Proposals*

Currently, Glass Lewis recommends against all members of the governance committee during whose tenure a shareholder proposal received majority support (excluding abstentions and broker non-votes), and the board has not begun to implement or enact the proposal's subject matter. Glass Lewis has expanded the policy so that in reviewing board responsiveness, it will take into consideration any conditions that may interfere with shareholders' ability to exercise the right proffered.

**Remarks and impact on issuers:** Glass Lewis enacted this change in reaction to the burdensome rules and processes that Allergan attached to its special meeting rights, a point of controversy in the company's ongoing proxy fight with Pershing Square Capital Management and Valeant Pharmaceuticals International. Allergan had added the provisions to its bylaws in 2013 in conjunction with a shareholder-approved certificate amendment granting holders of 25% of the shares the right to call special meetings, which was in response to a majority-supported shareholder proposal from the previous year.

Glass Lewis notes in its 2014 post-season report that in recent years, nearly all management proposals offering

<sup>1</sup> See ISS's 2015 policy updates at <http://www.issgovernance.com/file/policy/2015USPolicyUpdates.pdf>. See Glass Lewis's 2015 policy updates at [http://www.glasslewis.com/assets/uploads/2013/12/2015\\_GUIDELINES\\_United\\_States.pdf](http://www.glasslewis.com/assets/uploads/2013/12/2015_GUIDELINES_United_States.pdf) and [http://www.glasslewis.com/assets/uploads/2013/12/2015\\_GUIDELINES\\_Shareholder\\_Initiatives.pdf](http://www.glasslewis.com/assets/uploads/2013/12/2015_GUIDELINES_Shareholder_Initiatives.pdf).

shareholders special meeting rights have included various procedural limitations—holding requirements, blackout periods, and restrictions on the timing of the meeting and agenda items—and the resolutions invariably passed. While a management proposal that includes such limitations may not reach the level of Allergan’s extensive informational requirements, which were recently rescinded, issuers should expect greater proxy advisor and investor scrutiny of special meeting or written consent rights that contain exclusionary or prohibitive language.<sup>2</sup>

### *Independent Chairman*

ISS is adopting a holistic framework for evaluating shareholder proposals calling for an independent board chairman. Under the new approach, ISS will generally recommend in favor of these proposals, taking into account the targeted company’s board leadership structure, governance practices, and financial performance as outlined below (new factors are noted in the comments):

- **The scope of the proposal**

- Whether it is precatory or binding, and
- Whether it is seeking an immediate change or a policy that can be implemented with the next CEO transition.

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<sup>2</sup> Based on feedback from major shareholders, in mid-November Allergan repealed or revised the more onerous provisions of its special meeting bylaws. This included eliminating certain disclosure requirements regarding the proposing person and others acting in concert, along with the requirement that the proposing person hold shares in record name. Allergan also expanded the timeframe for the proposing person to update information in the special meeting request, and mandated that the board call a special meeting within 90 days of receiving a valid special meeting request rather than giving the board full discretion to determine the time of the meeting. See <http://www.sec.gov/Archives/edgar/data/850693/000119312514407765/d820355d8k.htm>.

❖ *Comment:* This is a new factor, though ISS has not historically supported binding or overly prescriptive shareholder proposals.

- **Current board leadership structure**

- Absent a compelling rationale, ISS may support the proposal under the following conditions:
  - Presence of an executive or non-independent chair in addition to the CEO,
  - A recent recombination of the chair/CEO role, and/or
  - A departure from an independent chair structure.
- ISS will also take into account the designation of a lead director and the effect any recent leadership changes may have on independent board leadership.

❖ *Comment:* ISS has added a factor singling out companies that have a separate, but non-independent chair or that have reversed course from an independent chair structure. It is unclear what ISS’s look-back period will be for “recent” leadership changes, or to what extent ISS will downplay the role of the lead director, which it now contends may not be an effective counter-balance to both an executive chairman and a CEO. Especially noteworthy is that ISS no longer lists specific duties that should be tied to the lead director position.

- **Governance structure**

- Independence of the board and key committees,
- Governance guidelines,
- Board tenure and its relationship to CEO tenure, and

- Other governance concerns, such as poor compensation practices, which will weigh in favor of supporting the proposal.

❖ **Comment:** *Board/CEO tenure is a new factor. ISS has not defined what it considers excessive tenure, but its QuickScore rating considers nine years to be a lengthy director term.*

● **Performance**

- One-year, three-year, and five-year total shareholder returns (TSR) relative to peers and the market as a whole. While poor performance will weigh in favor of supporting the proposal, strong long-term performance will be a mitigating factor in ISS deciding whether a leadership change is warranted.

❖ **Comment:** *The five-year performance factor is a new addition. ISS's previous criterion was one- and three-year TSR in the bottom half of the company's four-digit industry group unless there was a change in the CEO position during that time.*

**Remarks and impact on issuers:** ISS's policy revision creates more subjectivity around its evaluation of independent chair proposals. In the past, ISS primarily looked at whether the company had a lead director with a robust set of duties, strong board and key committee independence, no problematic governance practices, and no sustained financial underperformance. ISS states that under the new policy any single factor that may have previously resulted in a "for" or "against" recommendation may be mitigated by other positive or negative factors, though it is unclear how individual factors will be weighted. It appears that ISS will accord companies with strong financial performance more flexibility in their choice of board leadership.

Overall, ISS anticipates that these changes will result in its supporting a higher number of independent chairman resolutions. Based on its stated explanation for the revisions—a recombination of the chair/CEO roles at

Bank of America and Hewlett-Packard—the issuers most affected will be those that have switched from an independent to a non-independent chair in recent years.<sup>3</sup> In those cases, companies should provide in their proxy statements a compelling rationale for altering their board leadership structure.

In the last few years, ISS has backed a diminishing number of independent chair proposals—less than half in 2014 (48%) compared to 75% in 2012—because of the increasing prevalence of lead directors at targeted companies.<sup>4</sup> We note that many mainstream institutional investors are satisfied with a lead director structure—evidenced by the small subset of independent chairman proposals that receive majority support each year—and we would expect this trend to continue irrespective of ISS's recommendations.<sup>5</sup> Nevertheless, issuers should be mindful that ISS's opinions influence support levels. At companies where ISS rejected the proposal this year, investor support averaged 23.4%. In cases where ISS endorsed the proposal, investor support averaged 39.1%. Therefore, until there is more clarity on ISS's policy, issuers targeted with independent chair resolutions should evaluate the voting policies and practices of their top shareholders and conduct outreach as necessary to ensure a favorable voting outcome.

In conjunction with ISS's revisions, issuers should keep in mind that Glass Lewis maintains a stricter policy on board leadership. In addition to largely supporting independent chair resolutions sponsored by shareholders, Glass Lewis also recommends against the chair of the governance committee at companies that

<sup>3</sup> Of the 33 companies where ISS opposed the proposal in 2014, two companies had separate, but non-independent chairs, and five companies had recombined the chair/CEO roles within the past six years in conjunction with the appointment of a new CEO.

<sup>4</sup> In 2014, virtually all of the targeted companies had a lead director or, in some cases, a newly-appointed independent chair.

<sup>5</sup> Excluding abstentions and broker non-votes, four independent chairman proposals received majority support in 2014, seven in 2013, and four in 2012. Many of these instances were due to longstanding issues over executive compensation or lack of responsiveness to majority-supported shareholder resolutions.

have neither an independent chairman nor a lead director. As a result, Glass Lewis's policy has a broader impact on issuers. According to Glass Lewis's 2014 post-season review, 27.2% of S&P 500 companies have independent chairmen and 67.1% have lead directors. Among Russell 3000 firms, 35.2% have independent chairmen and 49% have lead directors.

### *Proxy Access*

In its 2015 guidelines, Glass Lewis has clarified its intent to generally support proposals granting proxy access rights to significant, long-term shareholders, whereas in the past it refrained from establishing any specific parameters because of the inherent case-by-case nature of these situations. Glass Lewis has also added board independence and diversity of skills, experience, background, and tenure to the list of factors it will consider when reviewing proxy access proposals, which also include company size, performance, responsiveness to shareholders, and other features.<sup>6</sup>

**Remarks and impact on issuers:** According to its 2014 proxy season review, Glass Lewis supported all of the shareholder proposals calling for a 3%/3-year proxy access regime, and opposed those proposing lower eligibility requirements.<sup>7</sup> ISS followed the same pattern in its 2014 voting recommendations, though it purportedly looks at similar company-specific features as Glass Lewis.

In 2015, both institutional and retail proponents are coalescing around the 3%/3-year access structure adopted by the SEC in 2010 but struck down by the D.C. Circuit. James McRitchie and Harrington Investments have jointly or separately filed 3%/3-year proxy access proposals at a half dozen companies, while New York City Comptroller Scott Stringer is

spearheading sweeping boardroom accountability campaign targeting 75 companies.<sup>8</sup> The recipients of the Comptroller's proposals include 33 companies in carbon-intensive industries, 24 companies with little or no gender or ethnic diversity on their boards, and 25 companies that received significant opposition to their 2014 SOP votes.

In view of the proxy advisors' universal backing of the 3%/3-year access proposals, issuers receiving them should engage with their key shareholders on the matter, particularly where the underlying issue is poor compensation practices. In 2014, six of these resolutions received majority support (excluding abstentions and broker non-votes), primarily due to repeat failed SOP votes. Four others received support in the 44%-47% range. Depending on the proposal sponsor, there may be opportunity for dialogue and withdrawal if compromises can be reached on other governance, compensation, or social/environmental concerns.<sup>9</sup> Short of that, issuers that are open to adopting proxy access should be mindful that more rigorous regimes—such as the 5%/3-year structure advanced by Kilroy Realty and Nabors Industries this year—have not been acceptable to the proponents for purposes of withdrawal. Similarly, it is unclear whether the SEC will allow omission where there is a competing management resolution on the ballot with more stringent access requirements. Whole Foods Market, which is proposing access rights for 9%/5-year

<sup>6</sup> See Glass Lewis's 2015 Proxy Paper Guidelines for Shareholder Initiatives at [http://www.glasslewis.com/assets/uploads/2013/12/2015\\_GUIDELINES\\_Shareholder\\_Initiatives.pdf](http://www.glasslewis.com/assets/uploads/2013/12/2015_GUIDELINES_Shareholder_Initiatives.pdf).

<sup>7</sup> In 2014, individual investors submitted proxy access proposals that would allow a group of small shareholders, each owning \$2,000 in stock, to nominate directors.

<sup>8</sup> See <http://comptroller.nyc.gov/wp-content/uploads/2014/11/Board-Room-Accountability-2015-Company-List.pdf> and <http://harringtoninvestments.com/shareholder-advocacy/past-resolution/>. McRitchie and Myra Young have also filed a 3%/2-year access resolution at CSP.

<sup>9</sup> This year, Walt Disney reached an eleventh-hour agreement with Hermes Equity Ownership Services, the Connecticut Retirement Plans and Trust Funds, and the California State Teachers Retirement System to withdraw their proxy access proposal in exchange for a commitment to appoint an independent board chairman in the future. In 2012, Pioneer Natural Resources persuaded Norges Bank Investment Management to withdraw a proxy access proposal in exchange for the company declassifying the board and adopting majority voting in director elections.

shareholders in 2015, is seeking no-action relief on this basis.

### *Director Independence*

Glass Lewis is adjusting the materiality standard it applies in determining the independence of directors who are employed by a professional services firm (e.g., law firm, investment bank, or consulting firm) where the company pays the firm, rather than the individual, for the services. Glass Lewis's current threshold is \$120,000. Going forward, Glass Lewis will consider the relationship immaterial where the amount represents less than 1% of the professional service firm's annual revenues, and the board provides a compelling reason why the director is considered independent.

**Remarks and impact on issuers:** The change will result in fewer directors being deemed non-independent by Glass Lewis, which may translate into somewhat fewer "withhold" recommendations if the director serves on a key board committee or if the board is less than two-thirds independent. We note, however, that ISS has a lower materiality standard for directors who provide professional services to companies (in excess of \$10,000 per year). Therefore, when taken together, the overall impact of this policy modification may be negligible.

### *Unilaterally Adopted Charter/Bylaw Amendments*

Both ISS and Glass Lewis will hold directors accountable for unilaterally adopting charter or bylaw amendments that negatively affect shareholder rights. These include, but are not limited to: classifying the board; diminishing shareholders' ability to call special meetings, act by written consent, remove directors without cause, or amend the bylaws; and restricting shareholders' ability to pursue full legal recourse through fee-shifting or mandatory arbitration bylaws.<sup>10</sup>

In these instances, Glass Lewis will recommend against the chair of the governance committee or all members of the committee. Glass Lewis will also oppose directors who implement negative governance provisions prior to the company's initial public offering (IPO), unless the board provides a sound rationale for adopting the measures or commits to putting the provisions to a shareholder vote within a year of going public. The extent of Glass Lewis's "withhold" recommendations at newly public companies will be based on the type of provision:

- Against all directors in the case of a poison pill with a five- to ten-year term, or in the case of a classified board or supermajority vote requirement with an unlimited duration.
- Against the chair of the governance committee (or in the absence of one, the chairman of the board) in the case of an exclusive forum provision.<sup>11</sup>
- Against the full governance committee (or in the absence of one, the chairman of the board) in the case of a fee-shifting provision.

<sup>10</sup> "Fee-shifting" or "loser pay" bylaws allow corporations to recover litigation expenses from investors who are unsuccessful in lawsuits against them.

<sup>11</sup> Exclusive forum provisions require that derivative actions, shareholder class actions, and other intra-company disputes be litigated exclusively in designated courts. Such provisions relieve companies from defending similar cases in multiple jurisdictions.

ISS's approach towards non-shareholder-approved charter and bylaw amendments is more nuanced and subjective. ISS will recommend against individual directors, committee members, or entire boards based on the following factors:

- The degree the provision impairs shareholder rights,
- The board's rationale for adopting the amendment,
- The timing of the amendment, such as a significant business development or prior to the IPO,
- Disclosure of engagement with shareholders on the matter,
- The board's track record in unilaterally adopting negative or entrenchment provisions,
- The company's ownership structure, and
- Other governance provisions.

**Remarks and impact on issuers:** ISS and Glass Lewis are essentially codifying what they have already been doing in practice regarding unilateral adoption of shareholder-unfriendly governance provisions, including several new types of bylaws that may chill shareholder litigation or proxy fights. In the past year, both proxy advisors have recommended against boards or governance committee members for unilaterally adopting fee-shifting or overly broad director qualification bylaws.<sup>12</sup> Since 2012, Glass Lewis has also applied this "withhold" policy to exclusive forum provisions that are instituted without shareholder approval.

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<sup>12</sup> The proxy advisors dislike director qualification bylaws that prohibit dissident nominees from receiving third-party payments ("golden leashes") for their board candidacy and service. The proxy advisors do not take issue with director qualification bylaws that merely require full disclosure of third-party compensatory arrangements.

The most significant change is the application of the policy to companies that have recently conducted IPOs. ISS noted that this reflects the increasing trend of companies adopting a suite of adverse governance provisions prior to going public.

Companies that have made potentially controversial charter/bylaw changes since their last annual meeting should disclose in their proxy statement their rationale for adopting the provision and their engagement with major shareholders on the amendments. To avoid any backlash against directors, issuers may also want to consider submitting the provision to a shareholder vote.

### *Litigation Rights*

ISS is expanding its policy regarding bylaws brought to a shareholder vote which materially impact shareholders' litigation rights. Currently, the policy only applies to exclusive forum provisions, but is being extended to fee-shifting and mandatory arbitration bylaws. ISS's case-by-case approach will take into account the following:

- The rationale for adopting the provision,
- Disclosure of past harm from shareholder lawsuits outside of the jurisdiction of incorporation or in which the plaintiffs were unsuccessful,
- The breadth of the application of the bylaw, including the types of lawsuits covered and the definition of key terms, and
- Governance factors, such as shareholders' ability to repeal the provision and hold directors accountable (annually elected board and majority voting in director elections).

ISS will oppose bylaws that mandate fee-shifting when the plaintiffs are not completely successful on the merits (i.e., where they are only partially successful).

Like ISS, Glass Lewis dislikes charter and bylaw provisions that limit shareholders' ability to sue

corporations. In its 2015 policy updates, Glass Lewis notes that it strongly opposes the adoption of fee-shifting bylaws. Per its current policy, Glass Lewis will oppose exclusive forum provisions put to a shareholder vote unless the company meets the following criteria:

- Provides a compelling argument as to how the provision benefits shareholders,
- Provides evidence of abuse of the legal process in other jurisdictions, and
- Has a strong track record of good corporate governance practices.

**Remarks and impact on issuers:** To date this year, ISS (and most likely Glass Lewis as well) has opposed every exclusive forum provision put to a shareholder vote, often because companies adopt them as a preventative measure and are unable to disclose past material harm suffered as a result of multi-jurisdictional lawsuits. Although all of the proposals passed, it was sometimes by narrow margins. Because forum selection provisions have become commonplace, issuers should conduct and disclose their outreach with major shareholders on the matter to deflect any backlash from the proxy advisors.

Relatively few companies have instituted fee-shifting bylaws since the Delaware state legislature is expected to take up a bill in 2015 which could prohibit such provisions at stock corporations.<sup>13</sup> Glass Lewis, however, has made it clear that it will oppose fee-shifting measures, while ISS will only accept narrowly crafted provisions, such as when a plaintiff is wholly unsuccessful in its claims. ISS has also raised objections to the fee-shifting variant adopted last month by Imperial Holdings, which requires a shareholder to obtain consents from 3% of the shareholders before filing a lawsuit against the company or its directors and

<sup>13</sup> Oklahoma is the first state to adopt a law mandating fee-shifting for all derivative lawsuits brought in the state, including those brought against non-Oklahoma companies. The law went into effect Nov. 1, 2014.

officers. The bylaw, which will be put to a shareholder vote at Imperial Holdings' 2015 annual meeting, was designed to ensure that any derivative or class-action lawsuit has a minimum degree of backing from other shareholders. In view of the legal uncertainties surrounding fee-shifting provisions, not to mention the potential negative reaction from investors, companies should refrain from adopting these measures in the near term.

### *Environmental and Social*

#### *Political Spending Disclosure*

ISS has provided more details on the factors it considers in analyzing shareholder proposals on political spending disclosure, specifically the type of oversight mechanism (management and board) and the level of disclosure on trade association and non-profit memberships. ISS's case-by-case approach will take into account:

- The company's policies and management and board oversight of its direct political contributions and payments to trade associations and other groups that are used for political purposes,
- The company's disclosure regarding its support of, and participation in, trade associations or other groups that make political contributions, including the comprehensiveness of the trade association membership disclosure, the nature of the company's participation in trade associations, and the level of transparency surrounding these expenditures, and
- Recent significant controversies, fines, or litigation related to the company's political contributions or political activities.

**Remarks and impact on issuers:** The update will have limited impact on issuers. ISS already supports a high number of political spending proposals (87% this year) since relatively few companies divulge details of

their involvement with trade associations and other non-profit groups.<sup>14</sup> Although ISS's recommendations are influential—resolutions backed by ISS this year averaged 31.9% support, while those opposed by ISS averaged 10.3% support—many mainstream institutional investors oppose or abstain on these resolutions, including Fidelity, Vanguard, and Capital Research & Management Co.'s American Funds.<sup>15</sup> Issuers receiving political activity proposals should examine the policies and voting histories of their major shareholders to gauge the potential level of support.

### *Greenhouse Gas Emissions*

ISS is strengthening the case-by-case factors it will consider on greenhouse gas (GHG)-related proposals sponsored by shareholders. It removed two of its previous criteria—"overly prescriptive requests for reducing GHG emissions" and "the feasibility of reducing GHG emissions given the company's product line and current technology"—in favor of expanded disclosures of companies' performance and progress on emissions reduction. Below are the factors ISS will review in analyzing GHG proposals:

- If there is disclosure of year-over-year GHG emissions performance data,
- If the disclosure lags behind industry peers,
- The company's actual GHG emissions performance,
- The company's current GHG emissions policies and oversight mechanisms, and
- If the company has been the subject of recent, significant controversies related to GHG emissions.

<sup>14</sup> According to the 2014 CPA-Zicklin Index, which rates the largest 300 S&P 500 companies on the quality of their political spending disclosure, 52% provide no disclosure of their trade association payments, and 22% only provide partial disclosure.

<sup>15</sup> See "Corporate Political Accountability and the Mutual Fund Vote" at <http://www.politicalaccountability.net/index.php?ht=a/GetDocumentAction/i/8174>.

**Remarks and impact on issuers:** This year, ISS supported all of the shareholder proposals that came to a vote on adopting quantitative goals to reduce GHG and/or methane emissions. Investor support averaged 25.9%. Therefore, this policy change is not likely to alter ISS's recommendations or significantly impact voting results.

### *Conclusion*

In preparing for next year's proxy season, issuers should review the proxy advisors' policy changes in conjunction with the voting policies and practices of their key shareholders to determine the overall effect on their 2015 proxy votes. Alliance Advisors will keep clients apprised of any additional developments as the proxy season gets underway.

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