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PROXY ADVISOR POLICY CHANGES FOR 2016

By Shirley Westcott **November 2015**

In preparation for the 2016 proxy season, proxy advisors Institutional Shareholder Services (ISS) and Glass Lewis & Co. have released their final policy changes for next year. ISS's updates take effect for annual meetings held on or after Feb. 1, 2016, while Glass Lewis's will apply to annual meetings on or after Jan. 1, 2016.[1]

Some of the key revisions will impact situations where the proxy advisors recommend against directors. These include serving on an excessive number of boards, unilateral board actions, adoption of exclusive forum provisions, nominating committee performance, and environmental and social (E&S) risk oversight. Other topics covered in the policy updates include pay disclosure at externally-managed issuers (EMIs), executive stock retention, supplemental compensation awards, and clarifications on E&S proposals.

Noticeably absent from ISS's release were several topics that were raised in its fall policy survey—board responses to proxy access proposals that received majority support, the duration of net-operating loss poison pills, equity compensation for directors, and cooling-off periods for non-independent directors. However, ISS plans to release additional updates in the next two months. In December, ISS will publish a frequently asked questions (FAQ) document addressing provisions in proxy access bylaws that it considers to be overly restrictive.[2] This will factor into its determination as to whether or not a board has adequately responded to a majority-supported proxy access proposal. The FAQ will also detail ISS's framework for analyzing proxy access nominations, which will differ somewhat from its framework for analyzing traditional board contests. Finally, in January, ISS will issue policy updates related to new types of shareholder proposals being filed for 2016.

This article provides an in-depth review of the proxy advisors' key policy changes for 2016 and their potential implications for issuers. Alliance Advisors will issue reviews of additional policy updates from the proxy advisors as they become available.

Governance

Overboarded Directors (ISS and Glass Lewis)

Both proxy advisors have strengthened their policies on overboarded directors in view of the increased time commitments associated with public company board service.

As indicated in the table below, ISS will recommend against directors who are not public company CEOs if they serve on more than five public company boards (the current limit is six). However, ISS is maintaining its current threshold of three public company boards for CEOs, though it may reexamine this policy in the future.

Glass Lewis will recommend against directors who are executive officers of public companies if they sit on more than two public company boards (the current limit is three) and against other directors who sit on more than five public company boards (the current limit is six).

Both proxy advisors are providing a one-year grace period before their new overboarding policies take effect in 2017. This will give affected board members

[1] See ISS's 2016 policy updates at http://www.issgovernance.com/policy-gateway/2016-policy-information/. See Glass Lewis's 2016 policy updates at http://www.glasslewis.com/assets/uploads/2015/11/GUIDELINES_United_States_20161.pdf.

[2] ISS has added proxy access as a new factor in its QuickScore governance rating, including the ownership threshold, holding period, group aggregation limit, and number of shareholder candidates allowed in access bylaws. For the time being, the factor is only being included for informational purposes and will have no impact on companies' governance scores.

ISS	Current Withhold Policy	New Withhold Policy
CEOs of public companies*	> 3 public company boards	> 3 public company boards
Other directors	> 6 public company boards	> 5 public company boards

Glass Lewis	Current Withhold Policy	New Withhold Policy
Executive officers of public companies*	> 3 public company boards	> 2 public company boards
Other directors	> 6 public company boards	> 5 public company boards

**Neither ISS nor Glass Lewis recommend against overboarded CEOs at their home company boards. Although ISS counts all of a CEO's subsidiary boards as separate boards, it will not recommend against the CEO at the parent company or at any of the >50% controlled subsidiaries of that parent.*

sufficient time to make any changes to their board commitments. During 2016 their reports will contain cautionary language towards directors whose board service would be excessive under the new policy.

Impact on issuers: The revisions will have a more pronounced impact on CEOs than on non-executive directors. Based on ISS data for U.S. annual meetings that occurred between July 1, 2014 and June 30, 2015, 61 non-CEO directors would be considered overboarded under ISS's new policy, compared to 21 non-CEO directors under its current guidelines. On the other hand, reducing the CEO board seat limit from three to two—as Glass Lewis has done—would result in 336 CEOs being considered overboarded, compared to 79 CEOs under the current threshold.

Large-cap companies may be less affected by the policy changes because many already self-regulate outside directorships. According to the Spencer Stuart U.S. Board Index 2015, 77% of S&P 500 boards restrict directors from accepting other board assignments. Currently, 88% of independent directors at S&P 500 firms have three or fewer corporate board affiliations, and only 12% have more than four.[3]

Issuers should review their top holders' policies regarding the optimal number of directorships as these may deviate from the views of the proxy advisors—evidenced by the mixed opinions ISS received on this topic in its recent policy survey.[4] Relatively few directors receive high opposition votes solely for being overboarded. According to ISS's 2015 post-season report, only one director at a Russell 3000 firm received less than majority support this year for holding too many board seats, and only four directors at S&P 500 firms received less than 70% support for being overboarded.[5]

Unilaterally Adopted Bylaws (ISS)

ISS is extending the period that it will recommend votes against directors for unilaterally adopting charter or bylaw amendments that materially diminish shareholder rights. Currently, ISS only opposes individual directors, committee members, or the full board at the next annual meeting.

Going forward, ISS will take a bifurcated approach. At established public companies, ISS will continue to recommend against directors who have unilaterally implemented a classified board structure or a

[3] See Spencer Stuart's U.S. Board Index 2015 at https://www.spencerstuart.com/research-and-insight/spencer-stuart-us-board-index-2015.

[4] Of the investor respondents to ISS's policy survey, 34% favored a limit of four board seats for directors who are not active CEOs, 18% favored a limit of five board seats, and 20% favored a limit of six board seats. For directors who are active CEOs, 48% of investors supported a maximum of two board seats, and 32% supported a maximum of three board seats.

[5] These occurred at Senior Housing Properties Trust, AvalonBay Communities, Boston Scientific, Caterpillar, and Joy Global.

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supermajority requirement to amend the charter or bylaws, or have eliminated shareholders' ability to amend the bylaws, until the provisions are either ratified by shareholders or unwound.

At newly public companies which adopted adverse provisions prior to or in connection with their initial public offerings (IPOs), ISS will oppose directors in subsequent years on a case-by-case basis. ISS will give significant weight to shareholders' ability to change the governance structure in the future through a simple majority vote and to hold directors accountable through annual director elections. Another mitigating factor will be a public commitment by the company to sunset the negative provisions or submit them to a shareholder vote within three years of its IPO.

Issuers should note that Glass Lewis does not oppose directors (typically the chair of the governance committee or entire committee) for unilateral board actions beyond the following annual meeting. Glass Lewis also provides a carve-out for recent IPOs if the company commits to submitting the negative provisions to a shareholder vote within a year of the IPO.

Impact on issuers: According to ISS, there has been a marked increase in the number of established public companies unilaterally adopting charter/bylaw amendments that reduce shareholder rights—10 cases in 2013, 64 in 2014, and 62 in 2015—as well as a significant percentage of recent IPOs and spin-offs with negative governance provisions.[6] However, only a portion of these related to board classification and supermajority voting requirements. To date this year, ISS has issued adverse recommendations for directors at 21 newly public companies and three existing public companies for unilaterally adopting a staggered board or supermajority voting provisions.

In view of these statistics, ISS's policy change will primarily affect recent IPOs. Because of the potential for ongoing negative recommendations against directors, companies will be under pressure to either repeal certain governance provisions or seek shareholder approval of them.

Exclusive Forum Provisions (Glass Lewis)

Glass Lewis is easing its policy on the adoption of exclusive forum provisions in connection with a company's IPO. In these instances, Glass Lewis will no longer automatically recommend against the governance committee chair. Instead, it will base any "withhold" recommendation on the presence of other provisions that limit shareholder rights, such as a classified board, supermajority voting, or fee-shifting bylaws.

Glass Lewis will continue to oppose governance committee chairs at companies that adopt forum selection provisions without shareholder approval outside of a spin-off, merger, or IPO.

Impact on issuers: This revision will only affect a small subset of companies that are newly public. In general, it is less risky for companies to unilaterally adopt exclusive forum provisions than to put them to a shareholder vote. Unlike Glass Lewis, ISS and many investors do not consider forum selection provisions to be materially adverse and will not oppose directors who unilaterally adopt them. In its 2015 post-season report, Glass Lewis indicated that no director nominee received a negative vote of over 20% solely due to the unilateral adoption of an exclusive forum bylaw.[7]

On the other hand, when forum selection provisions are put to a shareholder vote, both ISS and Glass Lewis have uniformly opposed them, notwithstanding their

[6] According to a Morrison & Foerster study of emerging growth companies that completed their IPOs in 2013 and 2014, 69% went public with classified boards and nearly 75% had supermajority vote requirements. A Davis Polk & Wardwell study of large IPOs at 46 non-controlled companies between 2001 and 2013 found that 70% of the boards had staggered terms, and 70% of the firms required supermajority approval of bylaw amendments.

[7] According to Glass Lewis's 2015 post-season report, 215 companies unilaterally adopted forum selection bylaws in 2015, and 115 companies unilaterally adopted such provisions in the first half of 2015. Glass Lewis identified over 500 NYSE-listed companies and over 250 NASDAQ-listed companies that maintain exclusive forum provisions in their charters or bylaws.

case-by-case policies. Although most provisions ultimately pass, the failure rate has been increasing. This year 25% of the proposals failed, whereas none failed in 2014 or 2013.

Conflicting Management and Shareholder Proposals (Glass Lewis)

In late October, the SEC issued new guidance on Rule 14a-8(i)(9), narrowing its interpretation of what constitutes conflicting shareholder and management proposals for purposes of exclusion.[8] Going forward, proposals that seek a similar objective but on different terms—such as proxy access—will not be considered a direct conflict because a reasonable shareholder could logically vote for both proposals.

In view of the SEC's new guidance, Glass Lewis clarified its approach to analyzing same-subject matter management and shareholder resolutions that appear side-by-side on ballots. Specifically, Glass Lewis will consider the following factors:

- The subject of the proposal,
- The benefit to shareholders from implementing the proposal,
- Material differences between the terms of the shareholder proposal and the management proposal,
- The appropriateness of the provisions in the context of a company's shareholder base, corporate structure, and other relevant circumstances, and
- The company's overall governance profile, particularly its responsiveness to shareholder proposals and its adoption of progressive shareholder rights provisions.

Impact on issuers: During 2015, there were seven instances of competing management and shareholder proposals on ballots dealing with proxy access and six dealing with special meeting rights. These lend some insight into Glass Lewis's approach towards conflicting resolutions.

In the case of proxy access, Glass Lewis favored the shareholder proposals calling for a 3% ownership threshold over management versions that contained a 5% ownership threshold. Only at Expeditors International did Glass Lewis support a more restrictive management resolution (3/3/20/20 access structure) instead of the shareholder resolution.

Glass Lewis's recommendations on dueling special meeting proposals were more varied. At companies that had no special meeting rights (AES, BorgWarner, and Capital One Financial), Glass Lewis backed the management resolutions, even though they contained higher ownership requirements than in the shareholder proposals (25% versus 20%). At companies that had special meeting rights but proposed reducing the ownership threshold to 25% (Dun & Bradstreet, Kate Spade, and NextEra Energy), Glass Lewis endorsed the lower threshold shareholder resolutions.

Although ISS has no similarly defined policy on conflicting proposals, issuers should be mindful of its 2015 recommendations. In the case of proxy access, ISS uniformly supported the shareholder resolutions over the more restrictive management versions. In the case of special meeting rights, ISS supported both the management and shareholder resolutions unless the management proposal was non-binding, in which case ISS only supported the more lenient shareholder resolution.

Notwithstanding the proxy advisors' recommendations, voting outcomes on conflicting resolutions were mixed. Companies had a high success rate of approving their special meeting proposals over the shareholder versions (all but one company). However, their success rate on proxy access proposals was 50/50 (excluding one

[8] See Staff Legal Bulletin 14H at http://www.sec.gov/interps/legal/cfslb14h.htm.

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instance where both the management and shareholder resolutions failed).

In view of this, companies that decide to offer an alternative management resolution in conjunction with a shareholder resolution should review the voting guidelines and practices of their major shareholders on the particular issue and stay abreast of any changes that they make to their policies.

Nominating Committee Performance (Glass Lewis)

Glass Lewis may recommend against the nominating committee chair if the board fails to ensure that it has directors with relevant experience—either through periodic director assessment or board refreshment—and the company has performed poorly.

Impact on issuers: Companies that have underperformed peers may face additional scrutiny of their board evaluation processes, their director tenures, and the extent of their board refreshment. Beyond that, Glass Lewis doesn't offer specifics as to how it will apply this policy.

Environmental and Social Risk Oversight (Glass Lewis)

Glass Lewis may recommend against directors responsible for risk oversight if the board or management fails to sufficiently identify and manage a material environmental or social risk that has or could potentially negatively impact shareholder value.

Impact on issuers: Glass Lewis is codifying its current practice in its guidelines. However, it is unclear what constitutes a "material" environmental or social risk under this policy.

Compensation

Executive Compensation at Externally-Managed Issuers (ISS)

ISS will recommend against the say-on-pay (SOP) proposal at externally-managed issuers (EMIs) if there is insufficient disclosure of executive pay arrangements to make a comprehensive analysis of pay for performance and conflicts of interest. Inadequate disclosure will be considered a problematic pay practice.

EMIs, such as many real estate investment trusts (REITs), typically do not directly compensate their executives. Instead, the executives are compensated by the external manager, which is reimbursed by the EMI through a management fee. There is usually very little disclosure of the details of these compensation arrangements or payments made to executives by external managers.

Impact on issuers: This policy affects a small subset of companies—ISS is aware of only 60 EMIs in the U.S. Most provide little or no disclosure of the executive compensation arrangements with the external manager.

In a comment letter to ISS, the U.S. Chamber of Commerce noted that EMIs have no control over how their external managers compensate their employees and often have no information about their compensation. The employees of the manager that serve as executives of the EMI typically perform services for the manager's other clients and are compensated for the totality of their services. Therefore, EMIs may not be able to provide the disclosure ISS is seeking and would face a negative recommendation on their SOP.

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Executive Stock Retention (ISS)

ISS is streamlining its policy on shareholder proposals that ask companies to require executives to retain a significant portion of the shares acquired through equity plans. Specifically, the revised policy clarifies that the proponent's suggested retention percentage/ratio and retention duration are two of the several factors that ISS will assess under its case-by-case approach. This eliminates the need for ISS to maintain separate policies tied to specified retention ratios.

Under the revised guideline, ISS will take into account the following factors in evaluating shareholder-sponsored stock retention resolutions:

- The percentage/ratio of net shares required to be retained,
- The time period required to retain the shares,
- Whether the company has equity retention, holding period, and/or stock ownership requirements and the robustness of such requirements,[9]
- Whether the company has any other policies aimed at mitigating risk taking by executives,
- Executives' actual stock ownership and the degree to which it meets or exceeds the proponent's suggested requirements, and
- Current and past problematic pay practices which may demonstrate a shot-term versus long-term focus.

Impact on issuers: Because the revision doesn't alter ISS's approach to stock retention proposals, the impact on issuers will be negligible. ISS supported all of the shareholder proposals on executive stock retention in 2015 and all but three during 2014 and 2013. The exceptions typically occurred at companies that had more rigorous equity retention policies than proposed by the proponents.

Glass Lewis and most shareholders do not support these proposals because they believe details about compensation plan design are best left to the compensation committee. Average support for stock retention resolutions was 23.4% in 2015, 22.3% in 2014, and 23.8% in 2013.

Other Clarifications

Supplemental Compensation Awards (Glass Lewis)

Glass Lewis has provided additional guidance on one-time and transitional compensation awards, such as sign-on and make-whole payments, that are made outside of the company's regular incentive plans. In these instances, Glass Lewis expects companies to provide a meaningful explanation of the amount of the awards, how they were determined, and why they are needed. In evaluating the appropriateness of such awards, Glass Lewis will take into account the executive's regular target compensation levels or the sums paid to other executives, including the recipient's predecessor.

[9] ISS considers a rigorous stock ownership guideline to be at least 10x salary and bonus for the CEO with declining multiples for other executives. A meaningful retention ratio should constitute at least 50% of the stock received from equity awards (on a net proceeds basis) held on a long-term basis, such as the executive's tenure with the company or a few years past the executive's termination with the company.

Environmental and Social Proposals (ISS)

ISS has made minor wording changes to the factors it considers when evaluating shareholder proposals on various E&S issues, including animal welfare, drug pricing/access to medicines, and climate change/greenhouse gas emissions. The updates primarily address variations seen in the proposals.

Conclusion

Other than the overboarding policies, which do not take effect until 2017, most of this year's policy changes will not affect a broad base of companies. Issuers should in any case stay attuned to any additional policy updates from the proxy advisors as well as from their major institutional shareholders.

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