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Proxy Advisor Policy Changes for 2018

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Overview

Institutional Shareholder Services (ISS) and Glass Lewis recently announced changes to their U.S. benchmark voting policies, which will take effect for annual meetings occurring on or after Jan. 1, 2018 (Glass Lewis) and Feb. 1, 2018 (ISS).[1] ISS has also issued frequently asked question (FAQ) documents dealing with executive compensation.[2] In January, it plans to add proxy voting guidelines on new shareholder resolutions anticipated for 2018.

ISS's primary revisions are limited to a few topics—poison pills, director compensation, and shareholder proposals on gender pay equity—and are largely in keeping with the draft policies it released in October. ISS has additionally made minor modifications and clarifications to other policies that were not included in its draft review.

In contrast, Glass Lewis's policy updates are more drastic in nature, though some do not take effect until 2019. These include taking action against boards that lack gender diversity, hold virtual-only annual meetings, go public with dual-class stock, or are unresponsive to significant shareholder opposition votes. Noteworthy is that ISS covered many of these topics in its fall policy consultation but refrained from making any related policy changes for the upcoming proxy season.

The proxy advisors' policy updates are reviewed in more detail below.

Poison Pills (ISS)

ISS has revised its policy towards directors who maintain a long-term poison pill (term of over one year) that has not been approved by shareholders, as follows:

- ISS will recommend against all board nominees every year. Currently, ISS recommends against all nominees every year if the board is classified, but recommends against nominees only once every three years if the board is annually elected.

- ISS will no longer exempt directors from adverse recommendations if they commit to putting a newly-adopted long-term pill to a shareholder vote in the following year.

- The above policies will apply to companies that adopted long-term pills prior to Nov. 19, 2009 (when ISS last updated its policy on pills). Currently, those pills are grandfathered and the directors are exempt from negative ISS recommendations.

ISS will continue to evaluate short-term pills (term of one year or less) on a case-by-case basis. However, going forward, ISS will focus on the rationale behind their adoption rather than on companies' governance.

Impact on issuers: The intent of the revisions is to simplify ISS's approach to poison pills and strengthen the principle that pills should be approved by shareholders. ISS anticipates that about 90 companies with grandfathered long-term pills will begin receiving adverse vote recommendations against their boards. ISS expects about 50 companies with annually elected boards to start receiving negative recommendations every year rather than once every three years.

[1] See ISS's U.S. policy updates at https://www.issgovernance.com/file/policy/2018-Americas-Policy-Updates.pdf and Glass Lewis's U.S. policy updates at http://www.glasslewis.com/wp-content/uploads/2017/11/US_Guidelines_2018.pdf and http://www.glasslewis.com/wp-content/uploads/2017/11/ShareholderInitiatives_2018_Guidelines.pdf.

[2] See ISS's FAQs at https://www.issgovernance.com/file/policy/Preliminary-U.S.-Compensation-FAQ.pdf and https://www.issgovernance.com/file/policy/2018-us-equity-compensation-plans-faq.pdf.

By way of comparison, Glass Lewis takes the following actions in regard to poison pill adoptions:

- Recommends against all incumbent board members *in the year after* adopting a long-term pill (term of over one year) without shareholder approval. If the board is classified, Glass Lewis will recommend against the remaining directors the next year they stand for reelection.

- Recommends against the governance committee members in the year after adopting a short-term pill (term of one year or less) without shareholder approval or adequate justification.

- Recommends against the entire board if it extended the term of a poison pill by one year or less in two consecutive years without shareholder approval or adequate justification.

Director Compensation (ISS)

ISS adopted a new policy on excessive non-employee director (NED) compensation which will result in recommendations against the board committee members who are responsible for approving/setting director pay. The policy will only apply when there is a pattern (two or more consecutive years) of excessive director pay without a compelling rationale. Currently, ISS only issues cautionary language in its analyses when it identifies outlier director pay levels over multiple years.

Impact on issuers: There will be no impact on issuers in 2018 because the negative recommendations will be triggered only after there has been a pattern of outsized director pay over several consecutive years. To determine outlier cases, ISS will compare individual NED pay totals to the median of all non-employee directors at companies in the same index and industry. Pay figures above the top 5% of all comparable directors would be considered extreme outliers.

Gender Pay Gap (ISS)

ISS has adopted a formal policy specific to shareholder proposals calling for reports on whether a gender pay gap exists at the company, and if so, what measures are being taken to reduce it. ISS will review such requests on a case-by-case basis, taking into account:

- The company's current policies and disclosure related to its diversity and inclusion policies and practices and its compensation philosophy and fair and equitable compensation practices;

- Whether the company has been the subject of recent controversy or litigation related to gender pay gaps; and

- Whether the company's reporting regarding gender pay gap policies or initiatives is lagging its peers.

Impact on issuers: The policy simply clarifies ISS's current approach to gender pay equity resolutions and is not expected to have a significant impact on its vote recommendations. In 2016 and 2017, ISS only supported the resolutions directed at technology firms, but not at companies in other industries.

In advance of the 2017 proxy season, Glass Lewis similarly codified its policy on gender pay gap resolutions, using factors comparable to ISS's to inform its case-by-case approach. However, Glass Lewis has typically backed more of these proposals than ISS because it will generally support well-crafted resolutions if the targeted company has not adequately addressed gender pay disparities and there is credible evidence that such inattention presents a risk to the company's operations and/or shareholders.

Although shareholder proposals related to gender pay equity averaged only 14.7% in 2017 and 16.9% in 2016—including a majority vote at eBay—an increasing number of companies are conducting pay audits. A recent Gartner survey of 78 Fortune 1000 companies found that 69% had begun taking steps in the past two years to address gender pay gaps.[3]

Board Diversity (Glass Lewis)

Board diversity campaigns were invigorated this year after BlackRock, Vanguard Group, and State Street Global Advisors (SSGA) prioritized this topic for their corporate engagements. While they infrequently back shareholder proposals to improve board diversity, both BlackRock and SSGA have begun opposing nominating committee members at companies that fail to show meaningful progress over time.[4]

In line with the stronger positions taken by these major asset managers, Glass Lewis will recommend against nominating committee chairs at companies with no board gender diversity beginning in 2019, unless there is a sufficient rationale for the absence of female directors or disclosure of a plan to address the lack of diversity. The negative recommendation may extend to the other nominating committee members based on additional factors, such as the company's size, industry, and governance profile.

ISS, for its part, will flag boards with no female directors in its 2018 proxy analyses, but will otherwise not make any adverse recommendations. ISS's recent policy survey found that 69% of investors consider it problematic to have no women on a public company board, but most prefer to address the issue through engagement.

Impact on issuers: Glass Lewis's policy change will primarily affect small and mid-sized companies. Currently, five S&P 500 companies and about one-fourth of Russell 3000 firms have no women on their boards, according to reports by BoardEx and SSGA, respectively.[5]

Going forward, issuers should expect to face increasing shareholder pressure to address gender and racial imbalances on their boards. In September, the office of the New York City Comptroller launched a new phase of its Boardroom Accountability Project by calling on 151 companies to provide a director skills and diversity matrix in their proxy statements, including a breakdown of directors' gender, race and ethnicity.[6] The intent is to drive boards to becoming more diverse, independent, and climate-competent by giving investors a "big picture view" of the criteria that boards deem appropriate in selecting directors.

According to Equilar, 45.1% of large-cap companies already disclose the gender makeup of their boards and 39.8% disclose the racial and ethnic composition. However, only 18.4% of large-cap firms and 7.7% of Russell 3000 firms included a director skills matrix in their 2017 proxy statements. R.R. Donnelley noted that the vast majority of disclosed matrices do not include the gender, race or ethnicity of individual directors, though some companies provide summary information for the board as a whole.

Virtual Meetings (Glass Lewis)

The growing trend towards virtual-only annual meetings has rankled some investors who feel that online forums limit their interaction with boards and managements and give companies the ability to sidestep difficult questions. According to ISS's policy survey, 44% of investor respondents dislike virtual-only

[3] https://www.washingtonpost.com/news/on-leadership/wp/2017/08/31/the-push-for-pay-transparency-is-only-growing-stronger-despite-trumps-rollback-of-equal-pay-rule/?utm_term=.3c4db83ea358

[4] SSGA reported that during the 2017 proxy season, it voted against directors at 394 U.S. companies that had all-male boards. BlackRock supported eight board diversity resolutions and additionally voted against nominating committee members at five of the firms.

[5] S&P 500 companies continue to show the most progress on board diversity. Spencer Stuart reported that in 2017, over half of incoming S&P 500 directors were women and minorities—the first time this has occurred in the 32 years it has produced its annual U.S. Board Index. See https://www.spencerstuart.com/~/media/ssbi2017/ssbi_2017_final.pdf?la=en.

[6] The New York City Comptroller's focus list includes 139 firms that have adopted proxy access and 12 firms that are likely to adopt it in response to a 2017 proposal that received majority support. See the Comptroller's letter and list of target companies at http://comptroller.nyc.gov/newsroom/press-releases/comptroller-stringer-nyc-pension-funds-launch-national-boardroom-accountability-project-campaign-version-2-0/.

meetings, though 87% consider hybrid meetings, which combine a physical meeting with a webcast component, to be acceptable. The New York City Pension Funds took a more aggressive stance by announcing in April that they would vote against governance committee members at companies that switched to cyber-only meetings.

In view of investor concerns, beginning in 2019 Glass Lewis will recommend against governance committee members at companies that plan to convene virtual-only meetings, unless the proxy statement contains "robust disclosure" that shareholders will have the same ability to participate as they would at an in-person meeting.

At this time, ISS is not adopting any formal policy regarding the format of shareholder meetings in the U.S. However, in European markets, where shareholders must approve amendments to the articles to allow for online meetings, ISS is implementing a new policy to support hybrid meetings but oppose virtual-only meetings. ISS took a similar approach at SITO Mobile's November annual meeting, where it opposed the ratification of a bylaw amendment permitting remote annual meetings, including those without a corresponding in-person meeting.

Impact on issuers: The number of companies that have eliminated in-person meetings is limited but growing. According to Broadridge Financial Solutions, 163 companies—including 14% of the S&P 500—held virtual-only meetings in the first half of 2017, compared to 122 companies during the same period in 2016. Only about 17 companies held hybrid meetings.[7]

Companies that are contemplating a shift to a virtual-only meeting should weigh the benefits—such as increased attendance and reduced costs and security risks—against potential pushback from shareholders, particularly if there are any contentious items on the ballot. Issuers should gauge the reaction of key shareholders beforehand, as well as adopt safeguards and mechanisms to replicate the interaction and transparency of a physical event. Best practices for conducting online meetings are addressed in a set of guidelines developed by Broadridge and an industry committee, which are expected to be updated in advance of the 2018 proxy season.[8]

Dual-Class Stock (Glass Lewis)

Snap's unprecedented initial public offering (IPO) of non-voting stock earlier this year has reignited the debate over multi-class shares with unequal voting rights. Investor groups have stepped up their campaigns to eradicate such structures, including persuading S&P Dow Jones and FTSE Russell to exclude certain multi-class companies from their broad market indices.[9]

In light of this, Glass Lewis has codified its position to generally recommend in favor of recapitalization proposals to eliminate dual-class stock with differential voting rights and against resolutions to adopt new classes of common stock. At companies that have gone public in the past year, Glass Lewis will take into account the presence of a dual-class share structure, in addition to other factors, in determining whether shareholder rights are being severely restricted indefinitely, thereby warranting a negative recommendation against directors. Directors will be exempted from an adverse recommendation if the provision contains a sunset or is put to a shareholder vote at the first annual meeting following the IPO.

ISS has a nearly identical policy on dual-class stock. However, in 2017 it eliminated the exception for newly public companies that committed to putting the provision to a shareholder vote since the outcome of such a vote is a foregone conclusion. Absent a sunset, ISS may continue opposing directors in subsequent years until the provision is unwound.

Impact on issuers: Glass Lewis's policy update only affects companies with multi-class share structures.

[7] For a list of companies that have held or scheduled virtual meetings, see https://east.virtualshareholdermeeting.com/vsm/home.

[8] See "Guidelines for Protecting and Enhancing Online Shareholder Participation in Annual Meetings" at https://www.broadridge.com/white-paper/guidelines-for-protecting-and-enhancing-online-shareholder-participation-in-annual-meetings.

[9] MSCI has extended its review of multi-class stock, which was begun in June. In the interim, it has temporarily banned new companies with unequal voting structures from the MSCI ACWI Investable Market Index and MSCI US Investable Market 2500 Index.

Votes at such companies are, in any case, largely symbolic because of the controlling entity's superior voting rights.

Although most investors stand behind the one share/one vote principle, they are divided on how best to approach this issue. Several large asset managers expressed disapproval of the index providers' recent decisions, which will deprive index-based investors of opportunities for returns. Short of regulatory action, BlackRock recommends that companies seek periodic shareholder approval of capital structures with differential voting rights, or at least equalize votes on key proxy decisions, such as executive pay and related-party transactions. Other investors, such as T. Rowe Price Group and Voya Investment Management, will vote against governance committee members at companies that are controlled via dual-class shares with super-voting rights.

Like the proxy advisors, organizations such as the Council of Institutional Investors and the Investor Stewardship Group favor sunset provisions which phase out high-vote stock over time.[10] Although sunsets are still rare, they are becoming more commonplace. According to a Stanford University study, only 18 of the 123 companies with dual-class stock have a time-based sunset—typically seven years. However, 28% of those companies that listed after 2009 included sunsets.

Because sunset provisions impose an arbitrary timeframe on companies, other alternatives are being explored to balance entrepreneurs' desire to pursue a long-term vision and investors' need to ensure management accountability. A group of Silicon Valley venture capitalists are developing a new exchange—the Long-Term Stock Exchange—which will require tenure voting, whereby an investor's voting power increases the longer he holds the stock. Academics at Stanford University advocate another approach—namely, giving low-vote shareholders the ability to elect a minority of the board.[11] To be effective, the authors conclude that this right should be coupled with proxy access so that low-vote shareholders can also nominate the minority directors since board-nominated candidates may not be sufficiently independent of the controlling shareholder.

Board Responsiveness (ISS and Glass Lewis)

Glass Lewis believes it is essential for boards to respond to any ballot item where a significant number of shares are voted contrary to management's recommendations, particularly in the case of compensation and director election proposals. For 2018, Glass Lewis is reducing its threshold for adverse shareholder votes—either in opposition to management proposals or in favor of shareholder proposals—from 25% to 20% of votes cast (excluding abstentions and broker non-votes). The change is due to "evolving investor sentiment." For companies with dual-class shares, Glass Lewis will examine the votes attributable to a majority of unaffiliated shareholders in determining whether a board response is warranted.

ISS has not established comparable voting thresholds regarding board responses to dissenting shareholder votes. Currently, ISS gives additional scrutiny to companies whose last say-on-pay (SOP) vote received less than 70% approval. In assessing the board's responsiveness to the vote, ISS will start expecting companies to disclose more information about their shareholder engagement efforts, including the timing and frequency of engagements and whether the independent directors participated, the specific concerns raised by the dissenting shareholders, and specific and meaningful actions taken to address shareholders' concerns.

Impact on issuers: The proxy advisors' policy changes will significantly increase the disclosure burden on companies to avoid negative director recommendations. ISS's enhanced disclosure requirements on shareholder engagement will impact over 200 companies whose SOP proposals received than 70% support this year.

Similarly, Glass Lewis's board responsiveness policy will extend to almost 250 additional companies on director election votes and 85 additional companies on SOP votes, based on 2017 results to date. An additional 38 companies will be expected to respond to

[10] A study by the University of Notre Dame found that the value premium of dual-class stock dissipates six years after the company's IPO, lending credence to the desirability of sunset provisions. See https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3062895.
[11] See the Stanford University study at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3001574#.

shareholder proposal votes, primarily dealing with independent board chairs, proxy access, environmental issues, and lobbying/political spending disclosure.

CEO Pay Ratio (ISS and Glass Lewis)

New disclosures of CEO/median employee pay ratios have been one of the most controversial issues leading up to the 2018 proxy season. Both ISS and Glass Lewis plan to display the pay ratio as a data point in their 2018 proxy analyses, but at this time do not intend to incorporate the ratio into their assessment of SOP proposals.

Impact on issuers: Issuers are unlikely to face any proxy voting fallout from pay ratio disclosures in the near term. ISS's policy survey found that 63% of investors intend to use the pay ratio data, primarily by comparing the ratios across companies or industry sectors and by looking at year-on-year changes. However, a number of institutional investors, such as BlackRock, Vanguard, and T. Rowe Price, have indicated that CEO pay ratios will not be a significant factor in their compensation analyses, though an outlier ratio within a company's peer group could trigger engagement.

For issuers, the primary challenge this coming proxy season will be in their internal and external communications around the pay ratio results. Recent polls conducted by Pearl Meyer & Partners and Willis Towers Watson found that nearly half of companies expect pay ratio disclosures to affect employee morale, but far fewer companies anticipate a negative reaction from shareholders or the media.

Pay-for-Performance Analysis (ISS and Glass Lewis)

For 2018, ISS is adding a Relative Financial Performance Assessment (RFPA) to its quantitative pay-for-performance (PFP) screens in evaluating executive compensation. This test compares a company's ranking to its peer group over three years with regards to CEO pay and financial performance—measured for most companies by ROE, ROA, ROIC, and EBITDA growth. This evaluation was initially introduced in 2017, but was only included in ISS's qualitative review.

Glass Lewis is not making any alterations to its PFP model, which ranks companies using an "A" through "F" grading system. However, its policy updates provided clarification that a "C" grade does not indicate a significant PFP lapse, but that pay and performance are generally aligned relative to peers. "D" and "F" grades reflect a disconnect between pay and performance, while "A" and "B" grades show PFP alignment but with lower compensation and higher performance relative to peers.

Impact on issuers: ISS's RFPA test will be applied as a secondary quantitative screen after the traditional three quantitative tests—Multiple of Median, Relative Degree of Alignment (RDA), and Pay to Total Shareholder Return (TSR) Alignment—have been calculated. The RFPA is designed to enhance the PFP evaluation by using a combination of financial metrics rather than the single TSR measure used in the RDA test. The RFPA may shift companies that scored a "medium" level of concern on the three primary screens to a "low" level of concern if their overall financial performance is strong. Conversely, the RFPA could move companies with weak financial performance from a "low" to "medium" level of concern.

Climate Change Risk (ISS and Glass Lewis)

Climate change will continue to be a major focal point in 2018 following landmark majority votes this year at Exxon Mobil, Occidental Petroleum, and PPL on proposals to assess the long-term portfolio impacts of public policies and technological advances to limit global warming to 2° C. over pre-industrial levels. Ten similar resolutions received over 40% support, in large part due to a shift in policy by several large asset managers—particularly Fidelity Management & Research, which backed every one of the 2° scenario proposals it voted on.[12]

Both ISS and Glass Lewis have revised their voting policies to reflect their general support of resolutions to disclose climate-related risks. ISS's policy now extends to proposals on how the company identifies,

[12] See ShareAction's report on institutional investors' 2017 voting patterns on climate change resolutions at https://shareaction.org/wp-content/uploads/2017/10/InvestorReport-ProxyVoting2017updated.pdf.

measures and manages such risks, which is in keeping with the recommendations of the Financial Stability Board's Task Force on Climate-Related Financial Disclosure (TFCD).[13] Glass Lewis has also clarified that it generally backs shareholder requests for climate change scenario analyses at companies in extractive or energy-intensive industries.

Impact on issuers: The proxy advisors' updates simply reiterate their current practice of supporting certain climate change-related resolutions. Companies that are heavily exposed to climate risk or targeted with shareholder proposals should review their disclosures against the TFCD's guidelines and stay apprised of their key shareholders' policies on this issue. In part due to activist pressure, several major investors—including BlackRock, Vanguard, and JPMorgan Asset Management—began supporting climate impact resolutions in 2017 and others could follow suit. For 2018, social investment funds have already filed resolutions at Cohen & Steers, Bank of New York Mellon, and T. Rowe Price requesting proxy voting reports that address inconsistencies between the firms' voting practices and their public stance on climate change.

Additional ISS Policy Revisions

Pledging

Since 2013, ISS has recommended against the full board or members of the committee that oversees risk at companies with problematic levels of director and officer stock pledging. ISS has codified its existing case-by-case approach, which takes into account the following factors:

- The presence of an anti-pledging policy that prohibits future pledging activity;
- The magnitude of the aggregate pledge shares in terms of total shares outstanding, market value, and trading volume;
- The disclosure of progress in reducing the magnitude of aggregate pledged shares over time; and
- Proxy disclosure that shares subject to stock ownership and holding requirements do not include pledged company shares.

Problematic Pay Practices

ISS has modified its list of problematic pay practices that trigger negative recommendations for the compensation committee members. ISS has eliminated two factors—non-shareholder approved transfers of stock options and burn rate commitments—and added two new ones—failure to provide an SOP frequency vote when required by SEC provisions and failure to provide an SOP vote when required by SEC provisions or under the company's declared vote frequency.

Categorization of Directors

ISS is standardizing its terminology across markets regarding director independence. In the U.S., directors will be categorized as executive director (rather than insider), non-independent non-executive director (rather than affiliated outsider), and independent director. Directors who were previously considered insiders because they owned over 50% of the stock will be categorized as non-independent non-executive directors.

Director Attendance

Going forward, ISS will no longer recommend against new directors who have served for only part of the year and attended less than 75% of their board and committee meetings. Absenteeism by new directors is often due to scheduling conflicts because the meeting schedules were established before the director joined the board.

Classified Board Opt-In

ISS has codified its longstanding practice of recommending against incumbent directors at companies that have opted into or failed to opt out of a state law requiring a classified board.

[13] See the TFCD's guidelines at https://www.fsb-tcfd.org/publications/.

Restrictions on Shareholders' Ability to Amend the Bylaws

ISS has tweaked its policy on binding shareholder proposals to recommend against the governance committee members if any of the company's governing documents (not just the charter) unduly restrict shareholders' ability to amend the bylaws.

Special Purpose Acquisition Companies

ISS has adopted a policy regarding special purpose acquisition companies (SPACs), which are formed temporarily to raise capital from public investors to make acquisitions. If the SPAC fails to complete a business combination within a specified timeframe, it must either extend its duration or dissolve. Because an increasing number of SPACs have submitted extension requests to a shareholder vote, ISS has developed a case-by-case voting guideline, which takes into account the length of the requested extension, any prior extension requests, any equity kickers, and the status of any pending transactions.

Additional Glass Lewis Policy Revisions

Overboarded Directors

Although there is no change to Glass Lewis's overboarding policy, it has clarified that it will apply the two-board seat limit for public executives (other than the company CEO) case by case to take into account part-time positions, such as executive chair. Specifically, Glass Lewis will look at the actual duties and responsibilities of the executive role along with company disclosures regarding the director's time commitments.

Proxy Access Fix-It Proposals

Glass Lewis has expanded its voting policy on proxy access to include its current approach to "fix-it" proposals, which seek to amend the terms of existing proxy access bylaws. Glass Lewis evaluates these resolutions case by case and will support well-crafted proposals that address features of a company's bylaw that unnecessarily restrict shareholders' ability to use proxy access. Glass Lewis generally opposes fix-it resolutions if the company's bylaw reasonably conforms to market practice.

During 2017, Glass Lewis opposed all of the proxy access fix-it proposals on ballots, which largely sought to eliminate or raise share aggregation limits to 40-50 shareholders and, in some cases, to also increase the board seat cap to the greater of two directors or 25% of the board. In contrast, ISS backed all of the fix-it resolutions, in keeping with its policy that proxy access structures should be no more restrictive than 3/3/25 with minimal or no limits on nominating group size. The resolutions were uniformly rejected by shareholders, with an average of 28.1% support.

Conclusion

The proxy advisors' most pronounced policy changes do not take effect until 2019, which gives issuers a one-year grace period to review their director compensation, board composition, and digital meeting technology and, if necessary, make adjustments or prepare additional disclosures to satisfy the revised guidelines. Companies affected by the updates will also have the opportunity to raise these issues with their major shareholders to ascertain to what extent they intend to follow the proxy advisors' new policies. Alliance Advisors will keep issuers apprised of any additional updates and developments as they prepare for the upcoming proxy season.