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PROXY ADVISORS FINALIZE 2014 POLICY UPDATES

By Shirley Westcott **January 2014**

With the new year underway, proxy advisors Institutional Shareholder Services (ISS) and Glass Lewis have now released their final policy changes and clarifications for the 2014 proxy season.

Additional ISS Updates

This week ISS issued additional guidance on how it will react to corporate bylaws that disqualify from service director nominees who receive third-party compensation payments, other than existing employment agreements, indemnification, or out-of-pocket expenses ("golden leashes"). At least 33 companies have adopted such bylaws in response to last year's proxy fights at Agrium and Hess where dissident hedge funds offered sizable incentive bonuses to their board nominees (see Alliance Advisors' December 2013 newsletter).

ISS considers these bylaws to be overly restrictive and will take the following actions in response:

- Unilaterally adopted bylaws: ISS may recommend against directors for a material failure of governance, stewardship, risk oversight, or fiduciary responsibility.
- Bylaws put to a shareholder vote: ISS will apply a case-by-case analytical framework, taking into account:
    - The board's rationale for proposing the bylaw,
    - Whether the bylaw materially impairs or delivers any off-setting improvements in shareholder rights, and
    - Any market-specific practices or views on the underlying issue.

ISS further stated that it does not object to bylaws that preclude from board service director nominees who fail to disclose third-party compensation payments. Such provisions provide greater transparency to shareholders. In an actual proxy contest, third-party compensation arrangements will be an explicit factor that ISS considers in evaluating the opposing director slates.

Glass Lewis, for its part, has not addressed director compensation bylaws in its 2014 policies, which could mean tacit approval of them. In its analyses of the Agrium and Hess proxy fights, Glass Lewis criticized the dissident compensation schemes, though in the case of Hess, still supported the insurgent's nominees. Glass Lewis was also silent towards a director compensation bylaw adopted by Provident Financial Holdings ahead of its November 2013 annual meeting, which erupted with a negative ISS recommendation against the board.

Glass Lewis Policy Changes

Like ISS, Glass Lewis only made minor changes to its policies for 2014. These are described below, alongside ISS's current policies on the same matters.

Board Responsive to Declassification Resolutions

Glass Lewis is taking a tougher stance towards boards who fail to take steps to implement a shareholder resolution to declassify the board that received majority support (excluding abstentions and broker non-votes) at the previous year's annual meeting. Glass Lewis will consider recommending against <u>all</u> nominees up for election who served throughout the prior year, rather than just the governance committee members, which is its current practice.

Although not as explicit in its policies, ISS will likely take the same action towards boards who fail to adopt shareholder mandates on declassification. In its 2014 policy updates, ISS stated that it would consider board responses to majority-supported shareholder proposals on a case-by-case basis in determining whether or not to recommend against directors. Because annually-elected boards are preferred by most investors, taking steps to fully implement a declassification proposal would most assuredly be the only acceptable response to ISS.

Poison Pills

Glass Lewis generally dislikes poison pills except those that are limited in scope or contain a qualifying offer clause. Currently, it recommends against all board members who served when a poison pill was adopted without shareholder approval within the prior 12 months.

For 2014, Glass Lewis has refined its policy in the case of short-term pills. Glass Lewis will consider recommending against the governance committee members if in the past year the board adopted a pill with a term of one year or less without shareholder approval and without adequate justification. To prevent abusive situations, Glass Lewis may recommend against the full board if it extended the term of a pill by one year or less in two consecutive years without shareholder approval.

Glass Lewis's carve-out recognizes the growing popularity of limited duration pills, which are often put into place in response to a perceived activist threat. According to FactSet Research, 36% of the 55 pills adopted by U.S. companies in 2013 had terms of one year or less, compared to 10% of the 93 pills adopted in 2008.

ISS has a similar, longstanding policy regarding the enactment of poison pills. ISS opposes all incumbent directors if they adopted a long-term pill (term of over one year) or if they renewed an existing pill, including one with a short duration (one year or less), without shareholder approval. However, it takes a case-by-case approach towards directors who adopted a new pill with a term of one year or less without shareholder approval.

Hedging and Pledging

In its 2014 updates, Glass Lewis outlined its views on stock hedging and pledging by executives, though it did not specify what actions it would take against companies where such practices have occurred.

Hedging: Glass Lewis believes hedging severs the alignment of executives' interests and those of shareholders. Therefore, companies should adopt strict policies to prohibit executives from hedging the economic risk associated with their share ownership in the company.

Pledging: Glass Lewis believes that the benefits of executive and employee stock ownership may outweigh the risks of stock pledging. Therefore, it will look at the facts and circumstances surrounding any pledging activity at a company, including:

- The number of shares pledged,
- Executives' pledged shares as a percentage of outstanding shares,
- An executive's pledged shares as a percentage of the executive's shares and total assets,
- Whether the pledged shares were purchased by the employee or granted by the company,
- Whether there are different pledging policies for purchased and granted shares,
- Whether the granted shares were time-based or performance-based,
- The company's overall governance,
- The volatility of the company's stock,
- The nature and cyclicality of the company's industry,
- The participation and eligibility of executives and employees in pledging,
- The company's policies on pledging and any waiver from these policies, and

- Disclosure of the extent of any pledging, particularly among senior executives.

In 2013, ISS similarly amended its policies to address hedging and significant pledging of company stock by executives and/or directors. ISS regards such actions as a failure of risk oversight and will recommend against individual directors, committee members, or the entire board. While any amount of hedging will result in a negative vote recommendation, ISS takes into account the following factors in evaluating the pledging of shares:

- Disclosure in the proxy statement of a policy prohibiting future pledging;
- The magnitude of aggregated pledged shares relative to total shares outstanding, market value or trading volume;
- Disclosure of progress or lack thereof in reducing the magnitude of pledged shares over time;
- Disclosure in the proxy statement that shares subject to stock ownership and holding requirements do not include pledged company stock; and
- Other relevant factors.

In its post-season report, ISS indicated that in 2013 it opposed 152 directors—typically audit or risk committee members—at 25 companies where executives had pledged a sizable number of shares.

Dual-Listed Companies

Glass Lewis has clarified its policies towards companies listed on exchanges in multiple countries. Where such companies are seeking approval of proposals in accordance with varying exchange- and country-specific rules, Glass Lewis will apply its country policies that are most relevant to each situation.

A company's country of incorporation is the primary basis for ISS's application of its various market-specific or region-specific policies. Other nuances may apply based on listing or specific voting items. For example, a U.S. company incorporated offshore may have some ballot items that are standard in the United States and others that are required by the local market (in which case ISS's local market policies apply). ISS applies its U.S. policies to companies that are considered domestic issuers by the SEC (i.e., file DEF 14As, 10-K annual reports, and 10-Q quarterly reports) and to companies listed on U.S. exchanges as foreign private issuers where disclosure is comparable to that of U.S. companies.

Conclusion

Issuers should take these policy changes under advisement as they prepare for the 2014 proxy season. Where appropriate, advance outreach to top holders may lessen the impact of any adverse proxy advisor recommendations. Alliance Advisors will apprise clients of any additional developments as the proxy season progresses.

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