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SEC Updates and Proxy Advisor Policies Give Shape to the 2020 Proxy Season

By Shirley Westcott **December 2019**

Overview

Revised proxy advisor policies, shareholder proposal submissions and a flurry of activity at the SEC are leaving issuers with plenty to digest in the coming months as the 2020 proxy season approaches.

Institutional Shareholder Services (ISS) and Glass Lewis have released their updated voting guidelines, which take effect for annual meetings on or after Jan. 1, 2020 (Glass Lewis) and annual meetings on or after Feb. 1, 2020 (ISS).[1] This year they produced no big surprises. Most of the revisions are clarifications of their existing policies and practices and in some cases only affect a small subset of companies.

Consistent with the preview circulated this fall, ISS's changes primarily pertain to problematic governance structures—particularly multi-class stock—at newly public companies, stock buybacks and shareholder proposals calling for an independent board chair. More significant, ISS is pulling the trigger on switching from GAAP to economic value added (EVA) metrics in its pay-for-performance (PFP) analysis of executive compensation. As announced last year, ISS's policy on board diversity will also kick in, as will its policy on excessive director compensation now that two years of pay data will be available.

Glass Lewis has similarly confined its updates to minor tweaks of its current policies and adding factors to its assessment of key board committees' performance. Its potentially most impactful change deals with companies' omission of shareholder proposals in the absence of explicit SEC concurrence, reflecting recent procedural changes to how the staff will review—or possibly not review—Exchange Act Rule 14a-8 no-action requests.

The SEC also issued updated guidance this fall—Staff Legal Bulletin (SLB) 14K—clarifying its views on ordinary business exclusions. The guidance aids issuers in developing more robust board analyses and steers shareholder proponents towards crafting resolutions that can withstand no-action challenges.

While not affecting the 2020 proxy season, the most pronounced development this fall was long-awaited revisions to the requirements for filing shareholder resolutions and the rules governing proxy solicitations and proxy advisory firms. While well-received by many in the corporate community, the proposed amendments are generating fervent criticism from the proxy advisors—including a lawsuit filed by ISS against the SEC—and from shareholder activists. Because of the proposals' far-reaching implications, issuers, investors and other interested parties are encouraged to submit their comments during the 60-day period following publication in the Federal Register (i.e., by Feb. 3, 2020).

Recent SEC activities and the proxy advisors' policy updates are discussed in more detail below.

[1] See ISS's 2020 policies at https://www.issgovernance.com/file/policy/latest/americas/US-Voting-Guidelines.pdf and Glass Lewis's 2020 policies at https://www.glasslewis.com/wp-content/uploads/2016/11/Guidelines_US.pdf. ISS has also issued a preliminary FAQ on its 2020 compensation policies at https://www.issgovernance.com/file/policy/latest/americas/US-Preliminary-Compensation-FAQ.pdf.

SEC Developments

Rule 14a-8 No-Action Requests

As announced in September, the SEC has streamlined its process for handling company requests to exclude Rule 14a-8 proposals. Beginning with the 2019/2020 shareholder proposal season, the staff may respond to some no-action requests orally, rather than in writing, or may decline to express a view at all, leaving the company to make its own determination.[2]

The Division of Corporation Finance (CorpFin) has indicated that it will continue to provide letter responses where it believes doing so would provide value, including novel issues or difficult topics, such as ordinary business or economic relevance exclusions. Where the issues are ordinary course or well-settled in prior no-action letters, companies will receive informal (oral) responses. CorpFin has given no indication of the types of proposals that will prompt it to decline to state a view. While this has been a rare occurrence in the past, it could force companies and proponents to litigate the excludability of a proposal in court.

To alleviate issuer and investor concerns over transparency, CorpFin has posted a chart on the SEC website tracking the staff's no-action positions under its new process.[3] The chart includes the name of the company and the proponent; the company's bases for exclusion; whether the staff granted, denied or chose not to comment on the no-action request; and hyperlinks to any response letter. The staff plans to update the chart once or twice a week.

SLB 14K

Following a review of 2019 no-action requests, the SEC issued SLB 14K in October to clarify its views on the exclusion of shareholder proposals under the ordinary business exception and exclusions for technical deficiencies in proponents' proof of ownership letters.[4]

Significant policy issue: In demonstrating that the policy issue raised in the proposal is not significant to the company—i.e., does not transcend ordinary business—the board's analysis should address the following:

- **Company-specific**: The policy issue's significance to the company specifically, not its overall significance.
- **Delta analysis**: Why the difference (delta) between the proposal's request and actions already taken by the company does not represent a significant policy issue to the company.
- **Prior votes:** How the board's view on significance was informed by prior votes on the proposal, including subsequent shareholder engagement, actions taken in response to the vote and other intervening events.

Micromanagement: In evaluating micromanagement, the staff examines whether the proposal seeks intricate detail or prescribes a specific strategy, method or timeline for addressing the issue. A proposal requesting that the company consider, discuss the feasibility of, or evaluate the potential for a particular issue would generally not constitute micromanagement.

This issue has come up in the last two proxy seasons where proposals specifying greenhouse gas (GHG) reduction targets—such as aligned with the Paris Agreement's goals—and in some cases within designated timeframes were successfully challenged on micromanagement grounds. Proponents are accordingly reframing their 2020 resolutions. For example, Trillium Asset Management's upcoming proposal at J.B. Hunt Transport Services requests a report on how the company *plans* to reduce its total contribution to climate change and align its operations with the Paris Agreement goals.

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[2] See the SEC's announcement on Rule 14a-8 no-action requests at https://www.sec.gov/corpfin/announcement/announcement-rule-14a-8-no-action-requests.

[3] See more on the SEC's 2019-2020 Shareholder Proposal No-Action Response chart at https://www.sec.gov/corpfin/shareholder-proposals-no-action and https://www.sec.gov/divisions/corpfin/shareholder-proposals-2019-2020.pdf.

[4] See SLB 14K at https://www.sec.gov/corpfin/staff-legal-bulletin-14k-shareholder-proposals.

Proof of ownership: For purposes of verifying a shareholder's eligibility to submit a proposal, the staff advises companies to take a plain meaning approach to interpreting proof of ownership letters, even when they do not adhere to the suggested format in SLB 14F.

Proposed Rules Governing Proxy Advisors and the Shareholder Proposal Process

Though having no effect on the 2020 proxy season, on Nov. 5, the SEC proposed long-awaited reforms of the shareholder proposal process and the regulation of proxy advisory firms.[5] The proposed amendments will be open for public comment for 60 days following publication in the Federal Register (i.e., until Feb. 3, 2020), though a number of commentators have requested an extension to at least 120 days. Once finalized, any new requirements will be subject to a one-year transition period to give the proxy advisors time to implement the necessary administrative measures to comply with the rules.

Modernization of the Shareholder Proposal Rule

The proposed revisions to Exchange Act Rule 14a-8 update the eligibility requirements to submit shareholder resolutions and the voting thresholds to resubmit proposals, which have been in place since 1998 and 1954, respectively. The intent is to ensure that a shareholder has a meaningful economic stake in the company before requiring the company and other shareholders to bear the costs of including a proposal in the proxy statement. The amendments would do the following:

Submission threshold: Replace the existing submission threshold—the lower of $2,000 in stock and 1% of the shares outstanding held for at least one year—with a tiered approach:

- $2,000 held for at least three years,
- $15,000 held for at least two years, or
- $25,000 held for at least one year.

In addition, investors would no longer be allowed to aggregate their shares to meet the filing thresholds as they are currently permitted to do.

Representative documentation: Require documentation to ensure that a representative filing a proposal on behalf of a shareholder is authorized to do so.

Proponent engagement: Require a proponent to provide information regarding his availability to engage with the company in person or via teleconference 10-30 calendar days after submitting the proposal.

One-proposal rule: Apply the one-proposal limit to each "person" rather than to each shareholder. This would prevent a representative or a shareholder from submitting multiple proposals at a given annual meeting.

Resubmission threshold: Raise the levels of support a proposal must receive to be resubmitted. Currently, a proposal may be excluded if in the preceding five years it received support of less than 3%, 6% or 10% if voted on once, twice or three or more times, respectively, and the last vote occurred in the past three years. The new thresholds would be 5%, 15% and 25% covering the same time periods.

The proposed rule would also add a "momentum" requirement that would permit exclusion of a proposal that shows declining support. This would apply if the proposal has been voted on three or more times in the past five years and in the most recent vote support was over 25% but less than 50%, but declined by 10% or more compared to the immediately preceding vote.

[5] See the SEC's proposed amendments to modernize the shareholder proposal rule at https://www.sec.gov/rules/proposed/2019/34-87458.pdf and its proposed amendments to improve the accuracy and transparency of proxy voting advice at https://www.sec.gov/rules/proposed/2019/34-87457.pdf. In the "request for comment" sections of the proposed rules, the SEC poses a series of 50-60 questions for specific feedback. To submit and/or review comments, see https://www.sec.gov/rules/proposed.shtml.

Regulation of Proxy Advisors

The proposed rules codify the SEC's previous guidance that proxy voting opinions constitute a proxy solicitation and are therefore subject to the filing and information requirements of the federal proxy rules. To continue to be exempt, the proxy advisors would have to meet certain conditions to ensure accuracy and transparency in their voting advice:

- Disclose material conflicts of interest in their proxy reports.
- Provide companies and non-exempt solicitors who file their proxy statements at least 25 days before the shareholders' meeting with an opportunity to review and give feedback on vote recommendations before being issued to clients.
- Upon request, provide companies and non-exempt solicitors with an opportunity to review and append their comments to the final proxy report via a hyperlink.

As a solicitation, proxy voting advice would be subject to the anti-fraud provisions of Rule 14a-9 which prohibit materially misleading misstatements or omissions. This would include a failure to disclose the methodology for formulating voting recommendations, the use of third-party sources of information, conflicts of interest, or the use of standards that differ materially from the standards and requirements set or approved by the SEC.

Proxy Advisor Policy Updates - Governance

Exclusion of Shareholder Proposals (Glass Lewis)

In conjunction with the SEC's new procedures for responding to no-action requests, Glass Lewis is taking a hardline approach towards companies that exclude shareholder proposals without written concurrence from the SEC.[6] It will generally recommend against the members of the governance committee if:

- Staff declines to state a view on exclusion and the company excludes the proposal, or
- Staff provides verbal, rather than written, no-action relief and the company excludes the proposal without a written record provided by the SEC or disclosure in the proxy statement of the staff's determination.

Discussion: As discussed earlier, the SEC has addressed concerns regarding a written record by providing a chart on its website tracking its formal and informal no-action responses. Therefore, the issue of an oral-only response is essentially moot.

The other part of Glass Lewis's policy runs counter to the SEC's position that "decline to state" should not be interpreted as meaning the proposal must be included in the company's proxy materials. There may be a valid legal basis for excluding the proposal. We note that ISS takes a similar approach as Glass Lewis in its governance failures policy: ISS will generally recommend against individual directors, committee members or the full board if a company omits a properly submitted shareholder proposal without obtaining a withdrawal from the proponent or a staff response or U.S. District Court ruling concurring that the proposal may be excluded.

Although SEC staff decisions to express no view on a no-action request have been infrequent in the past, it is uncertain how often they will arise going forward.

[6] Glass Lewis has an existing policy in place whereby in very limited circumstances it will recommend against the governance committee members if it believes exclusion of a shareholder proposal is detrimental to investors, *even if a company has successfully petitioned the SEC to omit it.*

Because of the risk of fallout from the proxy advisors—and potentially investors as well—companies may feel compelled to leave shareholder proposals on the ballot under this circumstance.

Initial Public Offering (IPO) Governance (ISS)

ISS is adding clarity to its position on newly public companies with problematic governance structures by bifurcating its existing policy.[7] The first specifies the adverse governance provisions that will result in a negative recommendation against pre-IPO board members—individual directors, committee members or the entire board: a classified board, supermajority vote requirements to amend the charter/bylaws or "other egregious provisions." A sunset provision (with undefined parameters) will be a mitigating factor.

The second policy pertains to newly public companies that have multi-class capital structures with unequal voting rights. ISS has created a framework for evaluating acceptable time-based sunset provisions which will mitigate a negative recommendation against the full board. In assessing the reasonableness of the sunset—which should be no more than seven years—ISS will consider the company's lifespan, ownership structure, and reasons for the selected duration.

ISS notes that even if a multi-class stock company has a reasonable sunset, it will still oppose the board members if the company has a classified board or a supermajority vote to amend the governing documents.

Under both policies, directors may continue to face negative ISS recommendations in subsequent years until the problematic structure is reversed or removed.

Discussion: IPO governance concerns are one of the most prevalent reasons for unfavorable proxy advisor recommendations towards board members. According to research by Sullivan & Cromwell, ISS opposed 369 Russell 3000 directors and three S&P 500 directors on this basis during the 2019 proxy season.[8] Although the directors experienced reduced support levels—84% on average—only four received less than majority support.

Similarly, Glass Lewis reported that it opposed 121 Russell 3000 directors in 2019 due to adverse IPO governance. Glass Lewis applies a broader range of exceptions to its policy than ISS: a sound rationale for the provision, a sunset mechanism, or a commitment to put the measure to a shareholder vote at the first annual meeting following the IPO.

Most investors dislike unequal voting structures and more aggressive action can be expected. The Council of Institutional Investors (CII), for example, is maintaining a list of "dual-class enablers"—directors responsible for going public in the last two years with dual-class stock not subject to a time-based sunset of seven years or less. It is encouraging its members to vote against these directors at other single-class boards where they serve in order to bring about a greater degree of accountability.[9]

Restrictions on Binding Shareholder Proposals (ISS)

Since 2017, ISS has generally recommended against governance committee members on an ongoing basis if a company's governing documents place undue restrictions on shareholders' ability to propose bylaw changes. These include an outright prohibition on the submission of binding shareholder proposals or share ownership/time holding requirements in excess of Rule 14a-8 (at least $2,000 in stock held for one year). For 2020, ISS is adding subject matter restrictions—such as lock-in provisions—to its list of unacceptable limitations.

[7] ISS classifies newly public companies as those that have emerged from bankruptcy or have completed a traditional IPO, spin-off or direct listing. Its problematic governance policy—which was originally adopted in 2016--applies to newly public companies that held their first annual meeting on or after Feb. 1, 2015. Glass Lewis categorizes newly public companies as those that completed an IPO or spin-off within the past year.

[8] See Sullivan & Cromwell's report at https://www.sullcrom.com/files/upload/SC-Publication-2019-Proxy-Season-Review-Part-2-ISS-Negative-Recommendations-Against-Directors.pdf.

[9] See CII's list of "dual-class enablers" at https://www.cii.org/dualclassenablers. Although only 7% of Russell 3000 firms have multi-class structures in place, their prevalence among IPOs has been growing in recent years. According to CII, 26% of the IPOs in the first half of 2019 had dual-class stock with disproportionate voting rights, up from 11% in 2018. Relatively few—four in 2019 and five in 2018—included a time-based sunset, which ranged from three to 10 years.

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In addition, ISS will not consider it a sufficient restoration of shareholder rights if a company proposes lifting the prohibition on shareholder-sponsored bylaw amendments but tacks on eligibility requirements in excess of Rule 14a-8. In such cases, ISS will continue opposing the governance committee members until shareholders are provided with an "unfettered" right to amend the bylaws.

Discussion: The policy change primarily affects a number of Maryland real estate investment trusts (REITs) where state law gives the board exclusive authority to adopt, repeal or alter the bylaws. Some companies have compromised by giving shareholders a limited ability to modify bylaws. According to Venable, 23 Maryland REITs have ring-fenced certain bylaws from shareholder revision, particularly those pertaining to D&O indemnification and bylaw amendment procedures.[10] At least 14 have adopted ownership requirements for shareholders to propose bylaw changes, ranging from 1%/1 year by up to five holders to 3%/3 years by up to 20 holders. Four of these were approved by shareholders—as well as Glass Lewis—in the past two years, but it appears that investor consent will not insulate companies from a negative ISS recommendation.

Though not addressed in the proxy advisors' policies, John Chevedden is circulating a new proposal for 2020 that goes beyond an "unfettered" shareholder right to amend the bylaws. It would require a non-binding shareholder vote on all bylaw amendments adopted by the board—whether substantive or non-substantive—other than those already subject to a binding shareholder vote. At least one target—Hewlett Packard Enterprise Company—is trying to omit the resolution as micromanagement, vague and indefinite and a violation of Delaware law.[11]

Board Gender Diversity (ISS)

As announced last year, ISS will begin recommending against the chair of the nominating committee at S&P 1500 and Russell 3000 firms if there are no women on the board. A firm commitment—disclosed in the proxy statement—to appoint a female director within a year will be considered a mitigating factor, but only for 2020 and not beyond.

Similarly, if a company currently has no female directors but had one in the previous year, ISS will expect it to provide a firm commitment to appoint a woman to the board within one year or else face an adverse vote recommendation.

Discussion: ISS's policy is in keeping with the guidelines of Glass Lewis and a number of institutional investors, but it expects a more definitive commitment—one year—for achieving board gender diversity. Companies that are laggards should anticipate increasing investor pressure. In its 2019 post-season report, ISS observed that a growing number of nominating committee chairs at all-male boards are facing shareholder dissent of 20% or more—36% in 2019 compared to 20% in 2018. At the same time, new milestones were reached this year: all S&P 500 boards now have at least one female director, while the percentage of women on Russell 3000 boards surpassed the 20% mark.

[10] See Venable's Nov 14, 2019 memo at https://connect.venable.com/29/1584/uploads/iss-releases-changes-to-its-proxy-voting-guidelines-for-2020.pdf.

[11] See Hewlett Packard Enterprise's no-action request at https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2019/cheveddenhp112219-14a8-incoming.pdf.

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Looking ahead, shareholder activists are broadening their diversity campaigns to include C-suite executives and racial and ethnic diversity. This fall, the New York City (NYC) Comptroller's office launched the third phase of its Boardroom Accountability Project by sending letters to 56 S&P 500 firms to adopt a "Rooney Rule" policy to consider women and people of color for every open board seat as well as for CEO appointments.[12] Complementary Rooney Rule campaigns are being conducted by the Midwest Investors' Diversity Initiatives and the newly launched Northeast Investors' Diversity Initiatives—a group of New England state treasurers and social investment funds.

Independent Board Chair – Shareholder Proposal (ISS)

ISS takes a holistic, case-by-case approach to shareholder proposals calling for an independent board chair. Its updated guidelines explicitly identify the factors that will likely result in ISS supporting the resolution:

- A majority non-independent board or non-independent directors on key committees,
- A weak or poorly defined lead director role,
- An executive or non-independent chair in addition to the CEO, a recent recombination of the chair/CEO role, and/or a recent departure from an independent chair structure,
- Board failure to oversee and address material risks facing the company,
- Board failure to adequately respond to shareholder concerns, or
- Board failure to intervene when management's interests are contrary to those of shareholders.

In applying its policy, ISS will now consider the proponent's rationale for the proposal. In addition, it will no longer make distinctions between precatory and binding shareholder proposals or whether the proposal seeks an immediate change in the chairman role or can be implemented at the next CEO transition.

Discussion: This enhancement gives issuers more insight into the factors that will drive a favorable ISS recommendation for independent chair proposals. Notably, ISS has supported far fewer of these resolutions in 2019—42%—than in prior years when it backed between two-thirds and three-quarters of them. Glass Lewis typically endorses 80%-90% of the proposals every year, but supported fewer in 2019 (80%) than in 2018 (89%) because of questionable targeting. Almost a quarter of the firms targeted this year already had an independent board chair or alternatively had a separate but non-independent chair or a policy to phase in an independent chair at the next CEO transition. All of the targeted companies with non-independent chairs had an independent lead director.

Supermajority Vote Requirements – Shareholder Proposal (Glass Lewis)

Both ISS and Glass Lewis favor repealing or reducing supermajority vote requirements. Similar to ISS's approach, Glass Lewis has clarified that it opposes the elimination of supermajority provisions at controlled companies where the measures may act to protect minority shareholders.

Exclusive Forum Clauses (Glass Lewis)

The proxy advisors generally dislike charter and bylaw provisions that limit a shareholder's choice of legal venue when bringing a suit against the company. Currently, Glass Lewis will recommend against the governance committee chair if during the past year a company adopted an exclusive forum provision without

[12] See the NYC Comptroller's press release on the Boardroom Accountability Project 3.0 at https://comptroller.nyc.gov/newsroom/comptroller-stringer-launches-boardroom-accountability-project-3-0-a-first-in-the-nation-initiative-to-bring-diversity-to-board-and-ceo-recruitment/. The NYC Pension Funds plan to increase their expectations of gender, racial and ethnic diversity in the future as reliable data become available. For the past two years, the Boardroom Accountability Project 2.0 pressed companies to disclose the skills, gender and race/ethnicity of individual board members in a standardized matrix.

shareholder approval. Going forward, Glass Lewis may make an exception to this policy if the forum selection clause is narrowly crafted to suit the unique circumstances facing the company or if it has a reasonable sunset.

Discussion: While beneficial, this policy modification may not have any significant effect on issuers. Even when companies seek shareholder approval of forum selection provisions, Glass Lewis and ISS largely oppose them, though investors almost invariably pass them.

The pool of affected companies is also limited. During the 2019 proxy season, Glass Lewis reported recommending against directors at four S&P 500 firms and 27 Russell 3000 firms for unilaterally adopting an exclusive forum provision. ISS has a general policy to recommend against individual directors, committee members or the full board if the board unilaterally amends the charter or bylaws in a manner that materially diminishes shareholder rights. However, the policy does not specifically single out exclusive venue provisions.

Share Buybacks (ISS)

Under its existing policy, ISS generally supports management proposals to institute an open-market share repurchase program in which all shareholders may participate on equal terms. ISS has expanded the scope of the policy to include proposals to grant the board the authority to conduct open-market share repurchases. In both cases, ISS's support will be contingent on the absence of potentially abusive practices, including greenmail, the use of share buybacks to manipulate executive incentive payouts, and impairment of a company's long-term viability (or a bank's capitalization level).

Separately, ISS will recommend case by case on management proposals to repurchase shares directly from specified shareholders, balancing the stated rationale against the possibility for misuse, such as repurchasing shares from insiders at a premium to market price.

This policy applies to U.S. domestic issuers (DEF 14A filers) listed solely on U.S. exchanges, regardless of their country of incorporation.

Discussion: The update codifies ISS's existing approach in the rare cases where a buyback may be misused. Because most U.S. companies can implement stock repurchases without shareholder approval, the revision will primarily impact financial institutions and cross-market firms.

New Director Nominees (ISS)

ISS has clarified that only first-time director nominees who have served on the board for less than one year will be exempt from adverse vote recommendations, such as for poor attendance or the adoption of problematic governance practices. "New nominee" connotes a director who is standing for election for the first time, which could encompass directors who have served for a number of years in the case of a classified board or a recent IPO. ISS's recharacterization is in line with the carve-outs used by Glass Lewis and various institutional investors.

Governance Committee Performance – Director Attendance (Glass Lewis)

Glass Lewis will begin recommending against the governance committee chair if a company does not disclose board/committee meeting attendance or does not adequately explain why a director failed to meet the 75% attendance threshold. This would be in addition to recommending against the director with the poor attendance record unless he has served for less than a year or missed meetings due to serious illness or other extenuating circumstances.

Discussion: In its 2019 post-season review, Glass Lewis reported that it opposed 45 Russell 3000 directors and four S&P 500 directors for poor attendance. Because absenteeism without a valid excuse is a common driver of shareholder opposition to directors, companies should be attentive to explaining excessive absences in their proxy statements.

Audit Committee Performance – Auditor Fees (Glass Lewis)

Glass Lewis will recommend against the audit committee chair if the company does not disclose the fees paid to the external auditor. This is in addition to other factors that may prompt opposition to the audit committee chair—the composition of the audit committee and frequency of meetings, the size of non-audit and tax fees relative to audit and audit-related fees, and failure to put auditor ratification on the ballot.

Proxy Advisor Policy Updates – Compensation

Company Responsiveness to Say-on-Pay (SOP) Opposition (Glass Lewis)

Glass Lewis has elevated its expectations regarding company responsiveness to a low SOP vote (20% or more opposition). Depending on the magnitude of shareholder opposition and the persistence of shareholder disapproval over time, Glass Lewis will expect a robust disclosure not only of engagement efforts, but also specific changes made in response to shareholder feedback. An inadequate response will result in Glass Lewis recommending against the SOP proposal in the following year.

Discussion: Glass Lewis's updated policy largely mirrors ISS's guidelines regarding company responsiveness to low (less than 70%) SOP approval. Although SOP support has averaged 91.6% to date this year, 14.2% of companies have received less than 80% approval (Glass Lewis's trigger) and 8.2% have received less than 70% approval (ISS's trigger). These firms will need to consider making the suggested disclosures to avoid a negative proxy advisor recommendation in 2020.

Compensation Committee Performance – SOP Frequency (Glass Lewis)

Glass Lewis will recommend against all members of the compensation committee if the board adopts a frequency for SOP votes other than the one approved by a plurality of shareholders.

Discussion: Most companies follow their shareholders' preference on SOP frequency votes. According to Willis Towers Watson, 91% of Russell 3000 firms adopted an annual frequency in 2017, the time of most companies' last frequency vote. Nevertheless, there were 127 Russell 3000 firms (4.2%) that continued their triennial cycle despite their shareholders favoring an annual SOP vote, according to Segal Marco Advisors.[13]

We note that ISS recommends case by case on compensation committee members and the SOP proposal if the board implements a SOP vote on a *less frequent basis* than the frequency that received the plurality of votes cast. This is less rigid than Glass Lewis's policy because it will not penalize compensation committees that hold SOP votes more often than what shareholders ratified.

SOP – New Factors (Glass Lewis)

Glass Lewis has expanded the factors it will consider when assessing SOP. These include whether the company has adopted any post-fiscal year compensation changes and whether it has made any one-time awards.

SOP – Short-Term Incentives (Glass Lewis)

Glass Lewis expects a robust disclosure of why a company has applied upward discretion—such as lowering goals mid-year or increasing calculated payments—in short-term bonuses or incentives.

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[13] See Willis Towers Watson's report at https://www.willistowerswatson.com/-/media/WTW/Insights/2017/08/Executive-Compensation-Bulletin-Preference-for-annual-say-on-pay-votes-grows-for-now.pdf. See Segal Marco Advisors' report at https://www.shrm.org/resourcesandtools/hr-topics/compensation/pages/shareholders-favor-annual-say-on-pay.aspx.

SOP - Contractual Payments and Arrangements (Glass Lewis)

Glass Lewis has codified specific design features that will trigger a negative recommendation on SOP. These include:

- Excessively broad change-in-control (CIC) triggers which provide for payouts absent termination of employment. If the disclosure does not specifically state that the CIC arrangement is double-trigger, Glass Lewis will assume it is not.
- Inappropriate severance entitlements, which will be assessed against the executive's target compensation, other executive packages, and the executive's predecessor package.
- Inadequately explained or excessive sign-on arrangements.
- Guaranteed bonuses, especially as a multi-year occurrence.
- Amended contracts that maintain poor practices. Glass Lewis expects companies to clean up problematic pay practices when renewing employment contracts, including excessive or modified single-trigger CIC arrangements, excise tax gross-ups and multi-year guaranteed awards.

Equity Compensation Plans – Evergreen Provisions (ISS)

ISS evaluates equity-based compensation plans case by case using a combination of factors—plan cost, plan features and equity grant practices—where positive factors may counterbalance negative ones using an Equity Plan Scorecard approach. ISS is adding evergreen provisions (automatic share replenishment) to its list of egregious features that are overriding factors for ISS opposing the plan.

PFP Evaluation – EVA Metrics (ISS)

As contemplated last year, ISS will start incorporating EVA metrics into its quantitative PFP model's secondary Financial Performance Assessment (FPA) screen. The FPA is one of four measures used to evaluate the alignment between executive pay and company performance.

In 2019, ISS displayed the EVA metrics in its reports, which gave companies a sense of how their three-year financial performance ranked against peer companies using the EVA data versus the current GAAP-based measures—ROIC, ROA, ROE and EBITDA growth. The GAAP metrics will continue to be displayed in ISS's proxy reports for informational purposes but will no longer be part of the FPA screen.

ISS plans to publish a white paper in the early half of December 2019 with more details on how EVA will be used in the PFP model.

Discussion: It is unclear at this time how this change will impact ISS's PFP evaluations and recommendations on SOP. Recent surveys by Pearl Meyer found that the vast majority of corporations (67%) had received no feedback from investors expressing a preference for including EVA concepts in their incentive plan design. In view of that, only 5% of companies polled currently use or plan to add EVA as an incentive plan metric in fiscal 2020. Another 24% may consider adding EVA in future years and 51% have no plans to add it at all.[14]

Director Pay (ISS)

Beginning in 2020, if there has been a pattern of two or more years of excessive non-executive director (NED) pay without a compelling rationale, ISS will recommend against the directors responsible for setting

[14] See Pearl Meyer's February 2019 survey at https://www.pearlmeyer.com/blog/economic-value-added-is-a-shortcut-that-doesnt-consider-nuance and its August/September 2019 survey at https://www.pearlmeyer.com/looking-ahead-executive-pay-practices-2020-executive-summary.pdf. See also the Pearl Meyer/NACD webinar deck, "EVA, the Good, the Bad, and the Complex" at https://www.pearlmeyer.com/eva-good-bad-and-complex-final.pdf.

the pay. Outlier pay is defined as NED compensation above the top 2%-3% of all comparable directors in the company's index and sector (two-digit GICS group).

Discussion: In its recent post-season report, ISS indicated that it had flagged over 100 Russell 3000 companies in 2019 for outsized director pay. About half of the companies provided a sufficient rationale for the excessive pay—onboarding grants to new directors, special service on a committee or a specific corporate event. The remaining companies may be subject to adverse recommendation next year if the high director pay persists without a valid explanation.

Gender Pay Equity – Shareholder Proposal (Glass Lewis and ISS)

Glass Lewis has clarified its case-by-case approach towards shareholder proposals dealing with gender pay equity. It will generally oppose requests to disclose global median gender pay gaps (unadjusted gender pay ratios) if the company has provided sufficient information about its diversity initiatives and how it is ensuring that women and men are paid equally for equal work.

The update pertains to a new initiative launched by Arjuna Capital in 2018, which looks at the median pay of all female employees versus the median pay of all male employees at a company. Unlike equal pay-for-equal-work data, the median pay gap shows the extent that women are underrepresented in higher paying jobs.

ISS also takes a case-by-case approach towards shareholder proposals to disclose pay data by gender and steps to reduce any gender pay gap. For 2020, ISS has broadened its policy to cover race- or ethnicity-based pay inequities, which may be the next frontier of shareholder campaigns.

Discussion: Glass Lewis's update simply codifies its current practice and as such will not alter its recommendations or vote results. In 2018 and 2019, Glass Lewis opposed all of the proposals to disclose median gender pay gaps, while ISS supported all of them. Nevertheless, the concept is gaining traction with investors: average support on these proposals increased from 10% in 2018 to 24.3% in 2019.

Other Issues

Although excluded from ISS's final updates, two issues raised in its fall policy survey—overboarded directors and climate change risk—could be revisited in the future.

Overboarded Directors

Currently, ISS recommends against directors who appear over-committed, using a limit of three total boards for CEOs and five total boards for other directors. In comparison, Glass Lewis applies a cap of two total boards for named executive officers (NEOs) and five total boards for other directors. Although some major investors—notably BlackRock and Vanguard—have adopted stricter overboarding policies in recent years, others, such as State Street, T. Rowe Price Group and BNY Mellon, have comparable or more liberal policies than the proxy advisors.

Interestingly, ISS's recent survey found that investors are coalescing around two total board seats for CEOs (45% of respondents) and four total board seats for other directors (42% of respondents). When last surveyed in advance of the 2016 proxy season, investors were more divided on the issue. For active CEOs, 48% considered two total boards to be an appropriate limit and 32% preferred three total boards. For other directors, 34% of investors polled favored a limit of four total boards, 18% favored five total boards and 20% favored six total boards.

Climate Change Risk

ISS also canvassed constituents this fall on what steps shareholders should take at companies that are not effectively reporting on or addressing climate change risk, dovetailing with its newly introduced Climate Awareness Scorecard.[15] Investors and issuers both ranked engagement as the most appropriate action, followed by supporting shareholder proposals. However, investors showed a strong interest in voting

[15] For more details on ISS's climate scorecard and other climate-related services, see https://rewards.aon.com/en-us/insights/articles/2019/iss-adds-climate-scorecard-to-proxy-reports,-recognizing-the-rise-of-sustainable-investing and https://www.issgovernance.com/esg/climate-solutions/.

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against specific directors—the board chairman, lead director or chair of the committee responsible for risk management.

In view of this sentiment, issuers should be prepared for more aggressive action on climate change in the 2020 proxy season. For example, Climate Action 100+—a coalition of 370 global investors—plans to make preventing "obstructive, negative or evasive lobbying" a cornerstone of its upcoming campaigns. In line with this, various members wrote to 47 large-cap firms in September to align their climate lobbying with the goals of the Paris Agreement, citing inconsistent lobbying activities as an investment risk. The letters ask the companies to either disassociate from trade associations that are lobbying against worldwide efforts to rein in climate change or to pressure them to change their positions.[16] So far, drastic action of this kind has been soundly rejected by investors and proxy advisors. A shareholder proposal at dual-listed mining company BHP to suspend its membership in certain industry associations received 22.2% support at the U.K. annual meeting and 27.1% at the Australia annual meeting this fall.

Separately, the NYC Pension Funds are escalating their approach towards major U.S. utilities to move to net-zero emissions by 2050. For 2020, they are calling for independent board chairs at Dominion Energy, Duke Energy and Southern to better oversee their "strategic transformation" to operating in a low carbon economy.[17]

Institutional investors themselves are facing pressure from shareholder activists over their voting records on climate change resolutions. Recent reports by Majority Action and ShareAction singled out BlackRock, Vanguard, Capital Group, T. Rowe Price and J.P. Morgan Asset Management as the worst performing asset owners with regard to climate-related proxy voting.[18] Of the 41 "climate critical" resolutions reviewed by Majority Action, BlackRock and Vanguard only supported five and four, respectively. At least 16 of the proposals would have received majority support if these large asset managers had voted in favor of them. In their own defense, BlackRock and Vanguard dismiss the outcry as little more than a "name and shame" campaign that disregards their extensive engagement with portfolio companies on climate change.

Looking Ahead

In the weeks ahead, issuers should be on the lookout for ISS's final FAQ regarding changes to its compensation-related policies, as well as any updates to institutional investors' voting guidelines applicable to the 2020 proxy season.

The SEC is also expected to propose rules on compensation clawbacks, which have moved to the short-term (less than one year) schedule in the fall 2019 Regulatory Flexibility (Reg Flex) Agenda.[19] Long-term agenda items still include universal proxy cards, proxy plumbing, board diversity and pay versus performance disclosure—the last of the rulemaking mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act.

In the coming months, Alliance Advisors will keep issuers apprised of other key developments that arise as they prepare for the upcoming proxy season.

[16] See the investors' press release at https://www.ceres.org/news-center/press-releases/200-investors-call-us-companies-align-climate-lobbying-paris-agreement.

[17] See the NYC Pension Funds' press release at https://comptroller.nyc.gov/newsroom/to-tackle-climate-crisis-and-decarbonize-the-countrys-polluting-power-utilities-comptroller-stringer-and-the-nyc-retirement-systems-call-for-independent-board-leadership/ and their proposals at https://comptroller.nyc.gov/wp-content/uploads/2019/11/Shareholder-Proposals-Independent-Chair_Part1.pdf.

[18] See Majority Action's report at https://static1.squarespace.com/static/5d4df99c531b6d0001b48264/t/5d8006692e5b035cf0d2b17f/1568674165939/assetmanagerreport2019.pdf and ShareAction's report at https://shareaction.org/wp-content/uploads/2019/11/Voting-Matters.pdf. In 2020, BlackRock, JPMorgan Chase and T. Rowe Price Group are facing shareholder resolutions to review incongruities between their proxy voting practices and public statements and pledges regarding climate change. Some of these are reprisals dating back to 2015. Most were withdrawn while those voted received only single-digit support.

[19] See the fall 2019 Reg Flex Agenda at https://reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST¤tPub=true&agencyCode=&showStage=active&agencyCd=3235.