Client Alert | Public Company Advisory / Capital Markets

ISS Releases 2018 Voting Policy Updates

November 2017

Authors: Colin Diamond, Michelle Rutta, Dov Gottlieb, Irina Yevmenenko

On November 16, 2017, Institutional Shareholder Services ("ISS") published updates[1] to its benchmark proxy voting policy applicable to shareholder meetings held on or after February 1, 2018. The policy updates are the culmination of ISS' policy development process, which includes consideration of the results of ISS' 2017-2018 Global Policy Survey[2] (the "Survey") as well as feedback received during various roundtable and group discussions with investors and corporate directors. For US companies, there are key updates in the areas of non-employee director pay, poison pills, shareholder proposals on gender pay gap and board gender diversity, pay-for-performance evaluation, board responsiveness to say-on-pay and pledging.

This client alert discusses the policy changes applicable to US companies.

Non-Employee Director Pay

In response to increasing investor interest in board compensation structure and pay packages, as well as steadily rising compensation for non-employee directors ("NEDs"), under ISS' updated policy ISS will make negative recommendations for board committee members who are responsible for setting or approving NED compensation when a "pattern of excessive NED pay" is identified in two or more consecutive years and where there is not a compelling rationale or other mitigating factors. Importantly, because the policy update focuses on a "pattern," this will not impact voting recommendations in 2018. Instead, negative recommendations will be triggered in subsequent years if a pattern of excessive NED pay is identified.

Shareholder Proposals on Gender Pay Gap

ISS will make case-by-case recommendations on shareholder proposals requesting a report on a company's pay data by gender, or a report on a company's policies and goals to reduce any gender pay gap, taking into account:

- the company's current policies and disclosure related to both 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, litigation, or regulatory actions related to gender pay gap issues; and
- whether the company's reporting regarding gender pay gap policies or initiatives is lagging its peers.

1 ISS' full "2018 Americas Proxy Voting Guidelines Updates" is available here.

2 The 2017-2018 ISS Global Policy Survey Summary of Results is available here.

Poison Pills

The table below summarizes ISS' changes to its evaluation of a company's poison pill if the poison pill has not been approved by shareholders, as compared to the current policy:

	Current ISS Policy	**Updated ISS Policy**
Long-Term Poison Pills	Recommend against all nominees to classified boards every year and recommend against all nominees to boards elected annually every three years.	Recommend against all board nominees every year, regardless of whether the board is classified. Commitments to put a newly adopted long-term poison pill to a vote the following year would not be a mitigating factor in director voting recommendations.
Poison Pills with "Deadhand" or "Slowhand" features	Recommend against all board nominees every year.	Removes specific policies related to "deadhand" or "slowhand" features. Recommend against all board nominees very year, regardless of whether the board is classified.
Grandfathered Ten-Year Poison Pills (adopted prior to November 19, 2009)	Exempt. No adverse recommendation against board nominees.	No longer exempt. If a ten-year poison pill has not been approved by shareholders, recommend against all board nominees annually.
Short-Term Poison Pills	Assess on a case-by-case basis the adoption (but not the renewal) of short-term poison pills. If the company has a compelling rationale for its adoption and has a generally good governance track record, no adverse recommendation will be triggered.	Assess on a case-by-case basis the adoption (but not the renewal or extension) of short-term poison pills. Greater focus on the company's rationale for adoption, rather than on its governance track record.

Board Diversity

In response to the Survey, which found that 69 percent of investors considered it problematic if there are no female directors on a public company board, ISS will now identify in its reports which boards have no gender diversity; however, it will not make adverse vote recommendations due to a lack of gender diversity. In addition, ISS revised its "Fundamental Principles" to state that boards should be sufficiently diverse to ensure consideration of a wide range of perspectives.

Pay-for-Performance Evaluation

In connection with its pay-for-performance analysis, ISS will add a fourth test to its quantitative screening for 2018 by examining the alignment of pay and financial performance. The new test, Relative Financial Performance Assessment (RFPA), was introduced in 2017 for information purposes only. RFPA compares the company's rankings to a peer group selected by ISS with respect to (i) CEO pay and (ii) financial performance in three or four metrics (which will vary depending on industry), in each case as measured over three years. Details of this new test will be provided by ISS in an updated white paper.

Say-on-Pay Issues

Board Responsiveness

The update refines and clarifies ISS' approach to assessing a board's responsiveness to the say-on-pay vote, which will now be evaluated as part of "Board Responsiveness" rather than "Board Accountability." If a company's prior say-on-pay vote received less than 70 percent support of votes cast, ISS will now take any additional shareholder engagement disclosure into consideration when deciding how to recommend on say-on-pay proposals and compensation committee members in the following year. ISS provided more detailed guidance regarding what it will look for in such disclosures, including (i) the timing and frequency of the company's engagements with major institutional investors, (ii) whether independent directors participated in such engagement in forming its vote recommendation, and (iii) the specific concerns voiced by dissenting shareholders along with the specific and meaningful actions taken to address such concerns in evaluating the board's responsiveness. ISS noted that it prefers independent director participation as it is more conducive for candid investor feedback. ISS is also placing more emphasis on feedback the company receives from investors who voted against say-on-pay.

Failure to Include Say-on-Pay Ballot Items

Formalizing ISS' existing practice, the update provides that ISS will recommend against the compensation committee if the company fails to include a say-on-pay ballot item when required by Securities and Exchange Commission rules or under its own say-on-pay frequency or if the company fails to include a say-on-pay frequency vote when required.

Pledging of Company Stock

Formalizing ISS' existing approach, if a significant level of pledges of company stock by executives or directors raise concerns, ISS may recommend against all members of a committee that oversees pledging, or the full board. ISS will consider the following factors when makings its recommendation relating to problematic pledging: (i) the presence of an anti-pledging policy, disclosed in the proxy statement, that prohibits future pledging activity; (ii) the magnitude of aggregate pledged shares in terms of total common shares outstanding, market value, and trading volume; (iii) disclosure of progress or lack thereof in reducing the magnitude of aggregate pledged shares over time; and (iv) disclosure in the proxy statement that shares subject to stock ownership and holding requirements do not include pledged company stock.

Removal of shareholder discretion on classified boards

ISS will generally vote against or withhold from the entire board of directors (except new nominees who should be considered case-by-case) if the company has opted into or failed to opt out of state laws requiring a classified board structure.

Board Responsiveness

ISS will vote case-by-case on members of the compensation committee (or, in exceptional cases, the full board) and the say-on-pay proposal if the board of directors implements an advisory vote on executive compensation on a less frequent basis than the frequency that received approval by a plurality of votes cast.

US Categorization of Directors

ISS is updating its US director categories to harmonize its categorizations across global markets. Directors will be categorized as Executive Director, Non-Independent Non-Executive Director and Independent Director (replacing Inside Director, Affiliated Outside Director and Outside Director). While most Inside Directors will be categorized as Executive Directors, the directors considered insiders due to their controlling interest in the company will be moved to the Non-Independent, Non-Executive Director category. This reclassification does not result in any vote recommendation changes, as under the old and new ISS categorizations, these directors are considered non-independent.

Board Independence

ISS will recommend voting against or withholding from non-independent directors (defined as Executive Directors and Non-Independent Non-Executive Directors under its revised director categorization) if any of the following circumstances exist:

- independent directors comprise 50 percent or less of the board;
- the non-independent director serves on the audit, compensation, or nominating committee;
- the company lacks an audit, compensation, or nominating committee so that the full board functions as that committee; or
- the company lacks a formal nominating committee, even if the board attests that the independent directors fulfill the functions of such a committee.

Shareholder Proposals on Climate Change Risk

ISS is updating its policy on climate change risk shareholder proposals to align it with the recommendations of the FSB Task Force on Climate-related Financial Disclosures.[3] ISS will generally recommend voting for resolutions requesting that a company disclose information on the financial, physical, or regulatory risks it faces related to climate change on its operations and investments or on how the company identifies, measures, and manages such risks. The factors to be considered are:

- whether the company already provides current, publicly-available information on the impact that climate change may have on the company as well as associated company policies and procedures to address related risks and/or opportunities;
- the company's level of disclosure compared to industry peers; and
- whether there are significant controversies, fines, penalties, or litigation associated with the company's climate change-related performance.

Special Purpose Acquisition Corporations (SPACs)[4]—Proposals for Extensions

Typically, SPAC founders have 18 months to sign a definitive engagement letter and two years from the time of the SPAC IPO to consummate an initial business combination, otherwise, the SPAC will be dissolved and the trust proceeds disseminated among investors. SPACs that have neither proposed nor consummated a business combination and are nearing their deadlines often request extensions of their deadlines by way of amendments to their charters and trust agreements. ISS will recommend voting case-by-case on SPAC extension proposals taking into account:

- the length of the requested extension;
- the status of any pending transaction(s) or progression of the acquisition process;
- any added incentive for non-redeeming shareholders; and
- any prior extension requests.

---

3 The Financial Stability Task Force on Climate-related Financial Disclosures includes both users and preparers of disclosures from across the G20's constituency covering a broad range of economic sectors and financial markets. It seeks to develop recommendations for voluntary climate-related financial disclosures that are consistent, comparable, reliable, clear, and efficient, and provide decision-useful information to lenders, insurers, and investors. The "Final Report: Recommendations of the Task Force On Climate-related Financial Disclosures (June 2017)" is available here.

4 SPACs are blank-check companies that raise pools of capital from investors through a public offering of shares and warrants (known as a Unit IPO) for the purpose of buying one or more companies (commonly referred to as an initial business combination). SPACs have no assets or business plan and their sole intent is to acquire an operating business.

Practical Considerations

While these policy changes are unlikely to result in a significant increase in recommendations contrary to managements' recommendations in 2018, the new policies are a strong indicator of where investors will be focused as we head into the 2018 proxy season. Companies should take these changes under advisement, including taking the following steps:

- Review any poison pills currently in place with the Board and consider the implications of putting the poison pill to a shareholder vote and whether shareholder support is likely. When considering adoption of a pill, companies should consider the rationale for and length of the pill and consult with legal counsel.
- The committee of the board that oversees NED compensation should review NED compensation year-over-year in relation to the company's peer group, including its ISS peer group, and check for NED outlier pay.
- Review the company's pay practices to identify any gender pay gaps and, if practicable, compare to peer companies. Companies that provide disclosure regarding gender pay practices should review their disclosures to ensure that they include meaningful explanations to the extent gender pay gaps are identified. Companies that have received proposals related to gender pay gap issues, or those that expect to receive such a proposal in the future, should pay particular attention to their disclosures on this point.
- For companies that completely lack diversity on their boards, consider adopting a board diversity policy.
- Consider enhancing disclosures related to shareholder engagement, particularly if a company's prior say-on-pay vote received less than 70 percent support of votes cast.
- Take a fresh look at existing engagement efforts with institutional investors throughout the year.

White & Case LLP
1221 Avenue of the Americas
New York, NY 10021-1095
United States

T +1 212 819 8200