

ISS Issues Proposed Policy Changes for 2018 Proxy Season

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On October 26, 2017, Institutional Shareholder Services (“ISS”) issued draft proposed policy changes for the 2018 proxy season (the “Draft Changes”).¹ The Draft Changes for US companies are grouped in three categories: director elections (non-employee director pay); gender pay gap proposals; and director elections (poison pills). If adopted, the changes will take effect for shareholder meetings on or after February 1, 2018. ISS is accepting comments via email to policy@issgovernance.com through 5:00 p.m. EST on November 9, 2017.

This client alert discusses the Draft Changes applicable to US companies.

Director Elections – Non-Employee Director Pay

Noting that compensation for non-employee directors (“NEDs”) has risen steadily in the past five years, and that investors are showing a growing interest in board compensation structure and pay packages, ISS proposes to “hold accountable directors who approve excessive NED pay without a compelling rationale or other justification.” Currently, NED compensation is broadly addressed under the fifth of ISS’ five Compensation Global Principles, which states that companies should avoid inappropriate pay to NEDs. Under its proposed new policy, ISS would 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 Draft Changes focus on a “pattern,” if adopted, they 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.

ISS’ Draft Changes reflect the findings of the 2017-2018 ISS Policy Application Survey² (the “Survey”), which indicated a strong investor preference for an adverse vote recommendation for directors where a pattern of excessive NED pay levels at a company has been identified. As the Draft Changes are focused on “extreme director pay outliers,” ISS expects this policy to have minimal impact for most boards. In the Survey, ISS specifically notes that a pattern of excessive director compensation may compromise director independence.

ISS has requested comments on the following issues:

- the circumstances under which such a pattern should *not* trigger a negative recommendation (e.g., one-time onboarding grants to new directors);

¹ The draft proposed policy changes can be found [here](#).

² The Survey results are available [here](#).

- the board members who should be held accountable when the company’s proxy statement does not disclose the board committee responsible for setting and/or approving director pay; and
- whether, in calculating a company’s average and median pay, ISS should include outsized pay packages to NED board chairs, lead directors, or other board members who receive outsized boardroom pay.

Gender Pay Gap

Shareholder focus on gender pay gap issues has been on the rise, with shareholders increasingly filing resolutions requesting reports regarding the gap in pay between genders within a company and information on how any such gap will be addressed. In response to this increased interest, the Draft Changes seek to revise ISS’ current “case-by-case” approach to social/environmental issues to reflect a slightly more nuanced approach to gender pay gap issues. Specifically, under the proposed Draft Changes ISS will recommend votes on requests for reports on a company’s pay data by gender, or a report on a company’s policies and goals to reduce any gender pay gap, on a case-by-case basis, taking into account certain enumerated factors:

- a company’s current policies and disclosure regarding diversity and inclusion, practices and compensation philosophy, and fair and equitable compensation practices;
- recent controversy or litigation regarding gender pay gap issues; and
- a company’s reporting, as compared to its peers, regarding gender pay gap policies or initiatives.

While the proposed change provides more specificity for analyzing gender pay gap matters, it does not represent a major shift in ISS’ current policy approach and is not expected to have a significant impact on vote recommendations.

ISS is seeking comments regarding any additional factors it should consider when assessing proposals requesting disclosure on a company’s gender pay gap.

Director Elections – Poison Pills

ISS is proposing to update its policy regarding short-term poison pills (those with a term of one year or less) and long-term poison pills (those with a term greater than one-year). The table below summarizes ISS’ proposed 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	Proposed Change in Policy
Long-Term Poison Pills	Recommend against all nominees to classified boards every year and recommend against all nominees to boards elected annually, once every three years.	<ul style="list-style-type: none"> • Recommend against all board nominees at companies with annual director elections • 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.	Recommend against all board nominees annually, regardless of whether the board is elected every three years or annually.

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	<p>Assess on a case-by-case basis the adoption (but not the renewal) of short-term poison pills.</p> <ul style="list-style-type: none"> If the company has a compelling rationale for its adoption and has a generally good governance track record, no adverse recommendation will be triggered. 	<p>Assess on a case-by-case basis the adoption (but not the renewal or extension) of short-term poison pills.</p> <ul style="list-style-type: none"> Greater focus on the company's rationale for adoption, rather than on its governance track record.

ISS anticipates that this policy will impact about 140 companies and is seeking comments on the following issues:

- whether ISS should continue to grandfather the ten-year pills adopted before November 19, 2009, despite the fact that they will expire soon;
- whether the rationale for adopting short-term poison pills is the most important factor to consider when voting on directors who adopted the pill;
- what other factors may be more important than the rationale for the adoption of a short-term poison pill; and
- whether ISS should consider as a factor a company's commitment to putting any renewal or extension of the short-term poison pill to a shareholder vote.

Practical Considerations

While ISS will not release its final policy until the latter part of November, companies should take these Draft Changes under advisement as they prepare for the 2018 proxy season, including taking the following steps:

- 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. ISS specifically noted that NED median pay at S&P 500 companies stood at approximately \$260,000 in 2016, which reflects a steady rise from median NED pay of \$228,000 in 2012.
- 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.
- Review any poison pills currently in place with the Board and whether negative director recommendations are likely in light of the proposed policy, and consider the implications of putting the poison pill to a shareholder vote and whether shareholder support is likely.

Notably absent from the proposed Draft Changes are any references to ISS' consideration of the CEO pay ratio. Both ISS and Glass Lewis made recent public statements (at conferences or in online forums) indicating that CEO pay ratios will not have any impact on analysis of, or vote recommendations relating to, say on pay proposals in 2018; however, both ISS and Glass Lewis intend to include pay ratio information in their reports. Furthermore, ISS may still make additional changes to its final policies. Finally, other changes pertaining to current policies (such as burn rate and pay-for-performance concern thresholds) are typically announced through updated ISS FAQs in

mid-December. Companies should pay close attention as these policies develop in order to be prepared for the 2018 proxy season.

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