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Client Alert

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ISS Issues 2018 Voting Policies Update

On November 16, 2017, Institutional Shareholder Services ("ISS") issued its updated proxy voting guidelines for the upcoming 2018 proxy season. Notable updates applicable to U.S. companies include new or revised policies:

- to respond to recurring patterns of excessive non-employee director compensation;
- relating to director elections at companies with poison pills; and
- to address shareholder proposals on gender pay gaps.

ISS also clarified its policies on a number of other topics. The full text of the 2018 proxy voting guidelines published by ISS may be accessed here.

Non-Employee Director Compensation

Under the new guidelines, ISS will recommend voting against board committees responsible for approving or setting pay for non-employee directors where there is a recurring pattern of excessive non-employee director compensation without a compelling rationale or other mitigating factors.

The new policy will apply only in situations where ISS identifies excessive non-employee director compensation over a period of two or more consecutive years, and ISS specifically noted that the new policy will not be applicable to its voting recommendations for the 2018 proxy season.

ISS recognizes that non-employee director compensation varies by industry and company size. For companies with a pattern of excessive non-employee director compensation, ISS will issue adverse vote recommendations for board committee members responsible for approving or setting the non-employee director compensation. ISS will not issue an adverse vote recommendation if the company provides a compelling reason for the compensation decision or if there are mitigating circumstances.

This policy update continues the trend of increasing scrutiny of director compensation, and ISS noted broad support among investors in its 2017–2018 Policy Application Survey for adverse vote recommendations based on a pattern of excessive non-employee director compensation. In the past few years, shareholders have challenged director compensation through both proxy contests and legal action. While not explicitly required by ISS or under SEC regulations, companies may want to consider including additional discussion of the process for setting non-employee director compensation, including any peer group comparisons, in future proxy statements, beginning with their 2018 proxy statement.

Director Elections at Companies with Poison Pills

ISS also updated its policies regarding shareholder rights plans, or "poison pills," to simplify the existing guidelines issued in 2009 while reiterating its views that shareholders should have the right to vote on poison pills.

The new policies provide that:

- ISS will issue annual adverse vote recommendations for *all* board nominees *every* year at a company that has not obtained shareholder approval of its long-term poison pill (i.e., a poison pill with a term longer than one year) not approved by shareholders. Under the current policies for boards elected annually, ISS recommended voting against board nominees only every three years.
- ISS will no longer consider as a mitigating factor a company's commitment to provide a shareholder vote on the poison pill in the following year.
- ISS will end the grandfathering provision, which exempted companies that had long-term poison pills when the original policies were adopted.
- There will no longer be a separate policy for poison pills with "deadhand" or "slowhand" features. This change will have no practical effect because, with the end of the grandfathering provision, all of the companies with these types of poison pills will be covered under the general rules.
- ISS will still evaluate poison pills with a term of one year or less on a case-by-case basis, but the new guidelines will focus more on a company's reason for adopting the short term poison pill than on the company's other governance policies.

Because these updates reaffirm ISS's long-held view that any poison pills should promptly be put to a shareholder vote, they are unlikely to have a widespread impact.

The updated policy does not specifically address rights plans adopted to preserve net operating losses, which we expect will continue to be evaluated under existing ISS policies on a case by case basis.

Shareholder Proposals on Gender Pay Gap

ISS adopted a new policy to address shareholder proposals on gender pay gap issues, specifically shareholder proposals requesting that a company report whether there is a gender pay gap at a company as well as on measures being taken to mitigate any existing gender pay gaps.

Under the new policy, ISS will consider proposals related to gender pay gaps on a case-by-case basis, taking into account the following four factors:

- the company's existing policies and disclosures on diversity and inclusion;
- the company's compensation practices (and whether they are fair and equitable);
- whether the company has been the subject of any controversies, litigation or regulatory actions related to gender pay gap issues; and
- a comparison of the company's disclosures regarding gender pay gap policies or initiatives to the disclosures of its peers.

The updated guidelines provide more clarity on how ISS will evaluate shareholder proposals related to gender pay gaps, versus the general ISS policies on shareholder proposals relating to diversity and equality of opportunity, and reflect the growing interest of institutional shareholders in gender diversity issues generally. ISS anticipates seeing more shareholder proposals on this topic in the coming years.

Gender pay gap and other environmental, social and governance (“ESG”) issues are becoming increasingly more prominent issues with institutional investors, and we expect to see more companies include disclosure of their ESG practices and policies in 2018 proxy statements.

Other Policy Changes

In addition to the three policy changes noted above, ISS made various other updates to its policies, some of which will have substantive effects.

Board Diversity

ISS added sufficient board diversity to the fundamental principles it considers in voting for board nominees and will now highlight boards that are lacking gender diversity (specifically, those with no female directors), although this will not lead to an adverse vote recommendation.

Board Accountability

- ISS will now issue an adverse vote recommendation for directors of companies that either opt into or fail to opt out of state laws requiring classified boards. This change will have an immediate impact on only a handful of companies in Indiana and Iowa, but it is an important signal that ISS is willing to penalize companies that choose to incorporate in states with laws that ISS views as unfriendly to shareholders.

- ISS also clarified that its policy on voting against or withholding votes from members of the governance committee will apply if a company’s *governing documents* (i.e., bylaws as well as charter) contain undue restrictions on shareholders ability to amend the bylaws.

Pledging of Stock by Executives and Directors

ISS clarified its existing position on pledging of stock by executives or directors. ISS will vote against the members of the committee that oversees risks related to pledging where ISS finds “excessing” pledging, considering the following factors:

- presence of an anti-pledging policy, disclosed in the proxy statement, that prohibits future pledging;

- magnitude of shares pledged, in terms of total shares outstanding, market value and 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

- any other relevant factors.

Compensation-Related Matters

- ISS clarified that, for companies with a say-on-pay approval below 70%, factors to be considered in determining the vote recommendation for compensation committee members and potentially the full board would include disclosure of (a) engagement efforts with major institutional investors regarding the issues that contributed to the low level of support should also include disclosure of the timing and frequency of engagements and whether or not independent directors participated, (b) specific concerns voiced by dissenting shareholder that led to the say-on-pay opposition and (c) specific and meaningful actions taken to address shareholder concerns.

- ISS expanded its pay-for-performance evaluation metrics to include the rankings of CEO total pay and company financial performance within a peer group (each measured over a three year period).

Shareholder Proposals on Climate Change

ISS updated its policy on shareholder proposals requesting disclosure on a board's evaluation of risk associated with climate change to clarify that ISS will generally vote for shareholder proposals that request company disclosure on the financial, physical or regulatory risks a company faces related to climate change on its operations and investments, or on how the company identifies, measures and manages such risks. These revisions are intended to align ISS policy with the recommendations of the Task Force of Climate-Related Financial Disclosures, released in a 2017 report.