

ISS 2020 Benchmark Policy Updates

U.S. Policy Updates

On November 12, 2019, Institutional Shareholder Services, Inc. (“ISS”) released its 2020 Proxy Voting Guidelines updates to be applied for shareholder meetings taking place on or after February 1, 2020. This year’s policy update process included an open comment period, running from October 7 to October 18, 2019, whereby governance stakeholders provided feedback on proposed new voting policies or potential policy changes slated for 2020. The full restated guidelines, which may contain further minor changes in addition to those described herein, are expected to be published later this month and certain frequently asked questions are expected to be published by early- to mid-December 2019.

For the U.S. market, ISS has introduced major updates on its policy changes in three existing categories: (i) simplifying their assessment of problematic governance structures for newly public companies; (ii) streamlining voting rationale for shareholder proposals requiring an independent board chair; and (iii) adding several specific qualifiers to management share repurchase program proposals. Minor clarifications and amendments were also made for executive compensation and other governance matters. No new policies have been added in addition to these guideline modifications.

Notably, the previously considered changes to ISS’s quantitative Pay-for-Performance model are now official: ISS will incorporate the use of Economic Value Added (EVA) metrics in the model’s secondary Financial Performance Assessment (FPA) screen. The updated Pay-for-Performance Mechanics whitepaper, including details on the introduction of EVA into the FPA secondary screen of the pay-for-performance quantitative model for U.S. markets, is expected to be published in early- to mid-December 2019.

Director Voting in Uncontested Elections

- **Exemptions for New Nominees**

This update modifies ISS’s previous definition of a “new nominee” as it pertains to voting on director nominees in uncontested elections, specifically regarding a problematic event or governance issue. The original text defined a new nominee as “any current nominee who has not already been elected by shareholders and who joined the board after the problematic action in question transpired”. Alternatively, if it is impossible to determine if the nominee joined before or after the problematic action, the nominee will be considered “new”, if he or she joined the board within the 12 months prior to the upcoming shareholder meeting.

The new policy text is slightly altered, describing a “new nominee” as one who is being presented for election by shareholders for the first time. Furthermore, recommendations on new nominees who have served for less than one year will be made on a case-by-case basis depending on the timing of their appointment and the problematic governance issue in question.

Kingsdale Insight: Modification of the existing policy provides coverage for a loophole regarding the original definition of “new nominee”. In the case of a classified board, it may be several years before a director is technically elected by shareholders. Similarly, a director may serve on the board of a newly public company for many years prior to IPO. By tightening this loophole and using less restrictive language in regard to timing, ISS may utilize a contextual approach to evaluating individual directors in the face of problematic governance issues and may analyze the culpability of these directors on a case-by-case basis, beyond mere time constraints.

- **Board Composition – Attendance**

ISS’s update with regard to director attendance narrows the open-ended caveat for new nominees with poor attendance for board and committee meetings, by specifying that a free pass will only be provided for directors who have served only part of the fiscal year. Although the language maintains that directors may receive an allowance for “acceptable reasons for absences”, case-by-case evaluation will only occur for directors that have served for less than one fiscal year, in keeping with ISS’s new definition for a “new nominee”.

Kingsdale Insight: By utilizing a sweeping exemption under ISS’s “new nominee” framework, this policy shifts focus towards a director’s service over the fiscal year, rather than the old definition of whether or not a director was previously elected by shareholders. This exemption should adequately protect directors who are appointed part-way through the year, and thus are not capable of attending meetings prior to the date they joined the board. We note that under this new framework, directors appointed to a board utilizing slate elections, or those that sat on the board prior to IPO, will not receive attendance protections under the new policy text.

- **Board Composition – Diversity**

This update specifies the timeline for ISS’s 2019 diversity policy update, by providing a stratified, case-by-case window for improving female representation at target boards. A hard limit has been provided for appointment of a female board member for companies completely devoid of representation, and a brief window of respite has been implemented to provide adequate time to replace departing women on boards lacking gender diversity. ISS will generally vote against or withhold from the chair of the Nominating Committee on boards where there are no women, however, three mitigating factors to this provision are provided:

- (i) Until February 1, 2021, a firm commitment, as stated in the proxy statement, to appoint at least one woman to the board within a year,
- (ii) The presence of a woman on the board at the preceding annual meeting and a firm commitment to appoint at least one woman to the board within a year, and
- (iii) Other relevant factors as applicable.

Kingsdale Insight: In last year’s diversity policy, ISS had neglected to provide an ironclad timeline for female representation. Now this has been codified, with minimal allowances, indicating a renewed push for greater diversity on U.S. boards. We note that the third point, addressing “other relevant factors as applicable” may be used as a window of argument for companies facing talent acquisition or turnover problems, or that operate within a sector with poor female representation overall. However, this will likely only serve as a mechanism to buy time, as failing to honor a commitment to increase diversity will almost certainly result in a negative voting recommendation at subsequent annual meetings.

- **Board Accountability – Problematic Structure – Newly Public Companies**

The update bifurcates the policy regarding problematic charter and bylaw provisions from the policy regarding problematic multi-class capital structure provisions for newly public companies. In previous renditions, these policies had been encapsulated by one policy, meaning the updated policy will add a layer of specificity to evaluating the capital structure components and provide a framework for addressing acceptable sunset structures of newly public companies, which generally include those emerging from bankruptcy, spin-offs, direct listings, and those who complete a traditional initial public offering.

Problematic Governance Structure:

ISS will generally vote against or withhold from directors individually, committee members, or the entire board (excluding new nominees, who will be considered on a case-by-case basis) if prior to, or in connection with the company's public offering, the company or its board adopts bylaws or charter provisions that are considered materially adverse to shareholder rights. The following properties are considered:

- (i) Supermajority vote requirements to amend the bylaws or charter,
- (ii) A classified board structure, and
- (iii) Other egregious provisions.

A reasonable sunset provision will be considered a mitigating factor. Furthermore, unless the adverse provision is reversed or removed, director nominees will be voted against or withheld upon in subsequent years on a case-by-case basis.

Problematic Capital Structure:

Under their new guidance on capital structure, ISS will generally vote against or withhold from the entire board (excluding new nominees, who will be considered on a case-by-case basis) if prior to the company's public offering, the company or its board implemented a multi-class capital structure, leading to unequal voting rights without subjecting the aforementioned structure to a reasonable sunset. In assessing the reasonableness factors considered include:

- (i) The company's lifespan,
- (ii) Post-IPO ownership structure, and
- (iii) The board's disclosed rationale for the sunset period used. No sunset period in excess of seven years will be considered reasonable.

As with the policy pertaining to governance structure, unless the adverse provision is reversed or removed, director nominees will be voted against or withheld upon in subsequent years on a case-by-case basis.

Kingsdale Insight: *ISS has frequently advocated for equal voting rights, logically leading to increased codification of how new entrants may adjust their governance and corporate structure to what has largely become the market norm. By breaking this guideline into two separate voting policies, ISS provides some clarity on what they consider problematic practices in each area and how the two separate voting policies are applied when forming director voting recommendations in certain situations. For instance:*

- *Some IPO companies with multi-class structures may choose to put in place reasonable time-based sunset requirements, but if these companies also elect to go public with classified boards and supermajority vote requirements to amend the governing documents, adverse vote recommendations on directors would still be issued under the existing IPO governance policy.*
- *On the other hand, it may be possible under the updated policy for an IPO company to receive no adverse recommendations if it has a reasonable time-based sunset on its dual-class structure, provides for an annually elected board and has no supermajority vote requirements in place.*

- **Board Accountability – Restrictions on Shareholders’ Rights**

This amendment provides additional color regarding how ISS will approach subject matter restrictions within a company’s governing documents and management proposals to approve or ratify requirements in excess of SEC Rule 14a-8. Specifically, ISS will recommend vote against or withhold from the members of the governance committee, on an ongoing basis, until shareholders are provided with an unfettered ability to amend the company’s bylaws or a proposal providing for such unfettered right is submitted for shareholder approval.

Kingsdale Insight: *By pressuring the governance committee to provide this mechanism, and removing obstacles, to shareholders’ ability to amend bylaws, ISS is responding to a general increase in the number of companies submitting proposals with requirements in excess of SEC Rule 14a-8. ISS clearly interprets these egregious requirements as oppressive to shareholders and is seeking to apply consistent pressure at the board level to promote the implementation of reasonable amendment provisions.*

Other Board-Related Proposals

- **Independent Board Chair – Shareholder Proposals**

Revision of this voting guideline is intended to codify the existing policy application. Despite maintaining a holistic approach, ISS has indicated six factors that are given “substantial weight” during the evaluation process. These factors are considerations that generally increase the likelihood of a recommendation in support of the proposal in question. Policy aspects that have been removed have generally been summed up by the new criteria, excluding the clause stating that one-, three- and five-year performance may act as a mitigating factor, which has been removed in its entirety.

The six factors contributing to a supporting recommendation are as follows:

- (i) A majority non-independent board and/or the presence of non-independent directors on key board committees,
- (ii) A weak or poorly defined lead independent director role that fails to serve as an appropriate counterbalance to a combined CEO/chair role,
- (iii) The presence of an executive or non-independent chair in addition to the CEO; a recent recombination of the role of CEO and chair; and/or departure from a structure with an independent chair,
- (iv) Evidence that the board has failed to oversee and address material risks facing the company,
- (v) A material governance failure, particularly if the board has failed to adequately respond to shareholder concerns or if the board has materially diminished shareholder rights, and
- (vi) Evidence that the board has failed to intervene when management’s interests are contrary to shareholder’s interests.

Kingsdale Insight: *Revision of this voting guideline is intended to codify the existing policy application by explicitly stating heavily-weighted factors in final judgement. We note that one addition to the list of substantial factors is poor response to shareholder concerns as a result of the 2019 Global Policy Survey. In addition, ISS indicates that evaluation remains a largely holistic process, and that the language adopted does not specify how the presence of some or all the aforementioned factors will result in a positive or negative recommendation.*

Capital Restructuring

- **Share Repurchase Program Proposals**

By codifying the existing approach to policy application, ISS's revision of this voting guideline is intended to expand its existing policy to include a recommendation of a vote for management proposals to grant the board authority to conduct open-market repurchases, and to provide specific cases where a negative recommendation may be warranted. The updated policy will apply to U.S. Domestic Issuers (DEF 14 filers) listed solely in the U.S., regardless of their country of incorporation. The following are four company-specific concerns that may lead to a recommendation against a proposed share repurchase:

- (i) Greenmail,
- (ii) The use of buybacks to inappropriately manipulate incentive compensation metrics,
- (iii) Threats to the company's long-term viability, and
- (iv) Other company-specific factors as warranted.

These four concerns will be evaluated against the stated rationale with further consideration for the repurchase authority to be abused- to repurchase shares from insiders at a market premium, for example.

Kingsdale Insight: *U.S. shareholders are generally supportive of share buybacks and are generally not accustomed to voting on the details of a buyback plan, with a few exceptions to this rule including certain financial institutions and U.S.-listed cross-market companies that may require shareholder approval by the law of their country of incorporation. ISS expanded this policy to include those issuers that require a shareholder vote and provide a safeguard against the egregious abuse of the share repurchase program. It is unlikely that many negative recommendations will be forthcoming, unless it is clear that such a program is significantly unbalanced in favor of insiders, who stand to profit via an offer price in excess of the market norm.*

Executive Compensation

- **Equity-Based and Other Incentive Plans – Evergreen Provision**

ISS has implemented a slight change to their equity-based and other incentive plan policy, addressing recent tax reform that eliminates the need for companies to obtain regular shareholder reapproval of plans. Concerns around evergreen provisions that replenish reserves automatically and circumvent regular shareholder approval have arisen. In conjunction with a significant drop (27% from 2017 to 2018) in the number of equity plans brought to a shareholder vote, ISS now considers evergreen features an overriding factor in the U.S. Equity Plan Scorecard analysis, adding such features to the list of egregious factors.

Kingsdale Insight: *Evergreen features will now be considered an egregious factor when evaluating equity-based and other incentive plans. This means, in practicality, any plan implementing an evergreen or automatic share replenishment feature will be voted against, regardless of other redeeming factors or an abundance of positive attributes. We note that this policy change has no material affect upon pre-existing plans that have already been approved or are not up for renewal. However, structural changes of such plans will be required when seeking approval for unrelated amendments or renewal.*

Social and Environmental issues

• Diversity – Gender Pay Gap

ISS has made a minor policy update intended to better align the current policy to capture the parameters of typical shareholder proposals for greater disclosure on pay gaps of all kinds. The new text states that ISS will support requests for reports regarding pay data by race or ethnicity, in addition to gender, as per the original text. This includes information regarding recent controversy, litigation or regulatory actions, and disclosure on the target company's pay gap policies or initiatives relative to their peers.

Kingsdale Insight: *By supporting an expanded scope of disclosure for pay gaps on racial and ethnic lines, ISS is taking their first foray into the social issue of diversity beyond gender. This may be an indicator of plans to implement expanded diversity policies across other ISS voting policies. However, as this policy only addresses shareholder proposals regarding pay gap disclosure, this is unlikely to materially affect most issuers at this time.*

SEC Regulation on Proxy Advisors

On November 5, an SEC panel voted along party lines, in a 3-2 vote, to issue proposed rules about proxy advisors. The proposed rules will be open for public comment for 60 days; comments can be submitted via SEC's website, [here](#). The proposed rules impose new conditions for proxy advisors to meet in order to qualify for exemptions from the existing proxy solicitation rules. One of the conditions requires the proxy advisors to share draft proxy papers with subject companies twice before such reports can be shared with the proxy advisors' clients. Other requirements include additional disclosures of methodology used to formulate advice and deviations from previous guidelines, third-party sources used, and conflicts of interests.

Kingsdale Insight

The codification of the proposed rules will likely be a lengthy process and not take effect during the 2020 proxy season. In our view, the proposed rules will make it more difficult for proxy advisors to qualify for exemptions from existing proxy solicitation rules, and also puts proxy advisory firms in a more difficult position to make independent and unbiased recommendations and make them available to their clients in a timely fashion. Put another way, the new rules will lead to a shift of power from shareholders to the hands of management. More importantly, if the rules do go into effect in the future, none of the potential outcomes as outlined below will necessarily benefit public issuers when it comes to engaging with shareholders:

1. Proxy advisors fully exit the "proxy voting advice businesses".
2. Proxy advisors continue to operate under the existing model and comply with the new rules, however, pass down the additional operating cost to their subscribers. In this scenario, the proxy advisors may also move the final proxy voting recommendations closer to the shareholder meeting dates.
3. Proxy advisors continue to operate under a different model by reducing its service to pure data aggregation and not providing actual proxy voting recommendations.

In each case, institutional shareholders will have to spend extra resources and/or time to analyze proxy materials and draw voting decisions, which may potentially diminish the opportunities and effectiveness of their engagement efforts. Therefore, in our view, the key issue here is not the proxy advisors themselves

but whether or not a company believes a shareholder is capable of making a fully informed decision, regardless of what ISS and Glass Lewis might say.

If you have any questions about this update, please feel free to contact Kingsdale's experts listed below to discuss directly.

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