Client Alert.

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ISS and Glass Lewis Release 2013 Voting Guideline Updates

By David M. Lynn

The proxy advisory firms Glass Lewis & Co. ("Glass Lewis") and Institutional Shareholder Services Inc. ("ISS") recently released the 2013 updates to their U.S. proxy voting guidelines. These updates will influence the recommendations that these firms make during the 2013 proxy season. Unlike in recent years, the updates do not reflect major revisions to policies, but rather reflect changes to specific areas of concern for the proxy advisory services and their institutional investor clients.

GLASS LEWIS UPDATES

This year, Glass Lewis updated a handful of its voting guidelines, following an update to the firm's guidelines on advisory votes on executive compensation ("Say-on-Pay votes") earlier this year. The latest changes to the guidelines will go into effect for shareholder meetings taking place after January 1, 2013. In addition to changes specifically relating to capital raising and share issuances below net asset value that are applicable to entities such as real estate investment trusts and business development companies, Glass Lewis updated the more broadly applicable voting guidelines described below.

Board Responsiveness

Glass Lewis has adopted a new section of its guidelines that articulates the firm's practice of addressing the responsiveness of a company's board of directors to situations where there is a vote of 25 percent or more "against" the Board's recommendation on the proposal, including "withhold" or "against" votes in the election of directors, "against" votes on management proposals, and votes in favor of a shareholder proposal. In calculating the 25 percent threshold, abstentions and broker non-votes are not included.

When a vote meets the 25 percent or more "against" threshold, Glass Lewis will conduct a more detailed review of the issues underlying the vote outcome and judge whether or not the board of directors has responded appropriately to that outcome. The analysis that takes place subsequent to the vote will consider publicly available information, including the proxy statement for the year following the vote. Glass Lewis will be examining these materials to determine if there are any changes that are not shareholder-friendly:

- at the board level;
- to the company's governing documents;
- to the company's policies or business practices; and
- to the company's compensation practices.

Previously, Glass Lewis had specifically articulated this 25 percent threshold in the context of Say-on-Pay votes.

Overboarding

The guidelines applicable to 2013 meetings will clarify that when a director who serves as an executive officer of a public company also serves on more than two other public company boards, Glass Lewis will recommend a vote against that director at the other public companies where he or she serves on the board, not at the company where the individual serves as both a director and an executive officer.

Equity Plan Share Counting

In evaluating equity compensation plan proposals, Glass Lewis will consider as part of its over-arching principles that “[p]lans should not count shares in ways that understate the potential dilution, or cost, to common shareholders.”

Board Committees

A new section of the Glass Lewis guidelines describes the firm’s approach to the role of directors who chair committees of the board of directors, and how Glass Lewis formulates committee-specific recommendations. This new section indicates that the chairman of each committee bears primary responsibility for the actions of the committee, and therefore committee-specific recommendations will often focus on the chairman of the committee as opposed to other individuals serving on the committee. In the event that it is determined that a vote against the chairman of the committee is warranted but the chairman is not standing for election, then Glass Lewis will not recommend against any of the committee members, but will express concern with regard to the committee chairman. In circumstances where there is no committee chairman or Glass Lewis is unable to determine who serves as the committee chairman, Glass Lewis will recommend against the longest-serving member of the committee (or the longest-serving board member if the longest-serving committee member cannot be determined).

Exclusive Forum Provisions

While Glass Lewis remains generally opposed to exclusive forum provisions, it has now indicated that it may consider a recommendation in favor of an exclusive forum provision if there are compelling reasons why such a provision would benefit of shareholders, there is evidence of abuse of legal process and the company has a demonstrated record of good corporate governance.

ISS UPDATES

ISS has released a summary of its voting policy changes for 2013, which will be effective for shareholder meetings taking place on or after February 1, 2013. The ISS changes focus on the firm’s pay-for-performance evaluation methodology, as well as targeted changes related to board responsiveness, director issues, and social and environmental proposals. ISS has indicated that it will provide further guidance on the policy updates in frequently asked questions to be released in December 2012.

Pay-for-Performance Evaluation

With the advent of mandatory Say-on-Pay votes in 2011, a great deal of attention has been directed to the ISS pay-for-performance evaluation and how that evaluation impacts the proxy advisory firm’s recommendations. For 2013, ISS has adopted changes to its peer group methodology, and will now include “realizable pay” as part of its reports for large-cap companies.

Peer Groups

The ISS pay-for-performance evaluation begins with a preliminary screening based on quantitative factors for the purpose of evaluating the relationship of compensation to the pay of an ISS-selected peer group. Under the revisions to the policy guidelines, ISS will incorporate information from the companies' self-selected pay benchmarking peer group in order to identify and prioritize GICS industry groups beyond the subject company's own GICS classification. ISS anticipates that this revised approach will draw peers from both the subject company's GICS group as well as from GICS groups represented in the company's peer groups, while seeking to maintain approximate proportions of these groups in the final peer group. The methodology will also initially focus on 8-digit GICS groups for the purpose of identifying peers that are more closely related in terms of industry. Further, when selecting peers, ISS will prioritize peers that (i) maintain the company near the median of the peer group; (ii) are in the subject company's peer group; and (iii) have chosen the subject company for its peer group. For the purpose of selecting more representative peer groups, the ISS methodology contemplates relaxing size requirements (particularly for very small or very large companies), and using revenue instead of assets for certain financial companies.

Realizable Pay

ISS will add a measure of "realizable pay" to the research reports for large-capitalization companies, recognizing a trend toward more disclosure and consideration of "realizable pay" as a means for evaluating compensation relative to performance. For the purposes of its reports, ISS will define realizable pay as the sum of relevant cash and equity-based grants and awards made during a specified performance period being measured, based on equity award values for actually earned awards, or target values for ongoing awards, calculated using the company's stock price at the end of the performance measurement period. For stock options and stock appreciation rights, ISS will re-value them with a Black-Scholes model, utilizing the remaining term and updated assumptions as of the performance period. ISS notes that the realizable pay that it calculates may "mitigate or exacerbate CEO's pay-for-performance concerns."

Say-on-Golden Parachute Recommendations

When formulating recommendations on advisory votes on golden parachute arrangements ("Say-on-Golden Parachute votes"), ISS has taken a case-by-case approach. Under the revised guidelines, ISS will consider existing change-in-control agreements maintained by the company's named executive officers, rather than focusing principally on arrangements that are new or extended. Recent amendments to agreements that incorporate the problematic features identified in ISS's policy will carry more weight in the overall evaluation.

Hedging and Pledging of Company Stock

ISS will now take a case-by-case approach in determining whether pledging of company stock rises to a serious concern for shareholders, and has included significant pledging of company stock as a failure of risk oversight for which directors could be held accountable (as opposed to as a consideration relevant to making a recommendation on a Say-on-Pay vote). In determining vote recommendations for the election of directors at companies that currently have executives or directors with pledged common stock, ISS will consider the following factors:

- the presence in the company's proxy statement of an anti-pledging policy that prohibits future pledging activities;

- the magnitude of aggregate pledged shares in terms of the total common shares outstanding or the market value or trading volume of the common stock;
- disclosure of progress (or lack thereof) in reducing the magnitude of aggregate pledged shares over time;
- disclosure in the proxy statement that stock ownership or holding requirements do not include pledged company stock; and
- any other relevant factors.

With regard to hedging, the updated policy notes that hedging company stock severs the ultimate alignment with shareholders' interests, therefore any amounts hedged will be considered a problematic practice warranting a negative voting recommendation on the election of directors.

Board Responsiveness to a Shareholder Proposal Vote

One aspect of board responsiveness that ISS considers in formulating voting recommendations with respect to the election of directors is whether the board of directors has acted when a shareholder proposal has received significant support in the past. ISS has determined to change the standard for determining majority support in the previous year from a majority of the shares outstanding to a majority of the shares cast, and also has added flexibility to recommend against members of the board as deemed appropriate, but not necessarily the full board.

As revised, the policy will provide that ISS will recommend a vote "against" or "withhold" from individual directors, committee members, or the entire board of directors as appropriate if:

- for 2013, the board failed to act on a shareholder proposal that received the support of a majority of the shares outstanding the previous year;
- for 2013, the board failed to act on a shareholder proposal that received the support of a majority of shares cast in the last year and one of the two previous years; and
- for 2014, the board failed to act on a shareholder proposal that received the support of a majority of the shares cast in the previous year.

ISS also has included in the revised policy more guidance as to the sufficiency of a company's actions responding to a majority-supported shareholder proposal. Responding to the shareholder proposal will generally mean either full implementation of the proposal or, if the matter requires a vote by shareholders, a management proposal on the next annual ballot to implement the proposal. Responses that involve less than full implementation will be considered on a case-by-case basis, taking into account:

- the subject matter of the proposal;
- the level of support and opposition provided to the resolution in past meetings;
- disclosed outreach efforts by the board to shareholders following the vote;
- actions taken by the board in response to its engagement with shareholders;
- the continuation of the underlying issue as a voting item on the ballot (as either shareholder or management proposals); and

- other factors as appropriate.

Director Attendance

Based on a concern about the quality of disclosure regarding director attendance at board and committee meetings, ISS has decided to update its policy to recommend an "against" or "withhold" vote on any director whose attendance "is questionable due to unclear and insufficient attendance disclosure."

Under the revised policy, ISS will generally recommend a vote "against" or "withhold" from directors (except new nominees, who are considered on a case-by-case basis) who attend less than 75 percent of the aggregate of their board and committee meetings for the period for which they served, unless an acceptable reason for absences is disclosed in the proxy statement or another SEC filing, which would generally be limited to the following:

- medical issues/illness;
- family emergencies; and
- missing only one meeting (when the total of all meetings is three or fewer).

The policy states that if the proxy disclosure is unclear and insufficient to determine whether a director attended at least 75 percent of the aggregate of his or her board and committee meetings during his or her period of service, ISS will recommend a vote "against" or "withhold" from the subject director.

Overboarding

Under its revised policy on overboarding, ISS will no longer count publicly-traded subsidiaries owned 20 percent or more by the parent company as one board with the parent company. Instead, each publicly-traded subsidiary will be treated as a standalone board for the purpose of determining if the director serves on more than six public company boards (or if a CEO serves on more than two public company boards).

Director Categorization

ISS is embarking on an effort to simplify its own categorization of directors, beginning with the definition of "Inside Director." In so doing, ISS has moved the consideration of director compensation to the "Affiliated Outside Director" category from the "Inside Director" category, and has adjusted the definition of "Inside Director" so that it will now provide that an "Inside Director" includes:

- a current employee or current officer of the company or one of its affiliates;
- a beneficial owner of more than 50 percent of the company's voting power (this may be aggregated if voting power is distributed among more than one member of a group); or
- a director named in the Summary Compensation Table (excluding former interim officers).

Social and Environmental Issues

ISS has adopted "overarching principles" for evaluating social and environmental proposals in all markets, indicating that ISS will recommend votes on a case-by-case basis, taking into consideration whether the proposal will protect shareholder value, in addition to consideration of the following factors:

- if the issues presented in the proposal are more appropriately or effectively dealt with through legislation or government regulation;
- if the company has already responded in an appropriate and sufficient manner to the issue(s) raised in the proposal;
- whether the proposal's request is unduly burdensome (scope, time frame, or cost) or overly prescriptive;
- what the company's approach is compared with any industry standard practices for addressing the issue(s) raised by the proposal;
- if the proposal requests increased disclosure or greater transparency, whether or not reasonable and sufficient information is currently available to shareholders from the company or from other publicly available sources; and
- if the proposal requests increased disclosure or greater transparency, whether or not implementation would reveal proprietary or confidential information that could place the company at a competitive disadvantage.

With regard to proposals seeking to link, or report on linking, executive compensation to sustainability criteria, ISS will now determine its vote recommendation on a case-by-case basis (rather than generally voting “against”) based on a consideration of the following factors:

- whether the company has significant and/or persistent controversies or regulatory violations regarding social and/or environmental issues;
- whether the company has management systems and oversight mechanisms in place regarding its social and environmental performance;
- the degree to which industry peers have incorporated similar non-financial performance criteria in their executive compensation practices; and
- the company’s current level of disclosure regarding its environmental and social performance.

Generally, ISS will recommend a vote against a proposal calling for an analysis of the pay disparity between corporate executives and other non-executive employees.

Finally, ISS has revised its policy regarding proposals requesting information regarding a company’s lobbying activities (including direct, indirect, and grassroots lobbying activities), policies or procedures, indicating that it will evaluate such proposals on a case-by-case basis considering the following factors:

- the company’s current disclosure of relevant policies and oversight mechanisms;
- recent significant controversies, fines, or litigation regarding the company’s lobbying-related activities; and
- the impact that the public policy issues in question may have on the company’s business operations, if specific public policy issues are addressed.

CONCLUSION

In anticipation of the 2013 proxy season, companies should carefully consider the changes to the proxy advisors’ voting policies and determine whether any actions should be taken now in anticipation of any upcoming vote on directors, Say-on-Pay, equity plans or shareholder proposals.

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