ISS Policy Updates for 2020 Proxy Season

by John O. Newell

Institutional Shareholder Services (ISS) has published its annual updates to its proxy voting guidelines, which will be effective for annual meetings held on or after February 1, 2020. The ISS updates include matters related to (1) board diversity, attendance, and chair independence; (2) "problematic" governance and capital structures of newly public companies; and (3) evergreen provisions in equity and other incentive plans, "inappropriate" share repurchase plans, and reports on pay gaps that do not include race or ethnicity with gender. Companies should also note that 2020 will be the first year in which existing ISS policies on excessive non-employee director pay may result in negative voting recommendations. This client alert discusses these ISS updates in more detail below.

Board Gender Diversity. In 2019, ISS adopted a policy, effective for meetings held on or after February 1, 2020, to recommend a vote against or withhold for the chair of the nominating committee (or other directors on a case-by-case basis) for Russell 3000 or S&P 1500 companies that had no women on the board. This policy will now apply to meetings held on or after February 1, 2020. However, for companies with no women directors on the board, until February 1, 2021, ISS may consider as a mitigating factor a firm commitment by the company in its proxy statement to appoint at least one woman to the board within a year. Similarly, for companies that had at least one woman on the board at the preceding meeting, ISS will consider a firm commitment to appoint at least one woman to the board within a year as a mitigating factor.

Board Attendance. ISS policies generally provide that ISS will recommend a vote against or to withhold for directors who attended less than 75% of their board and committee meetings in the aggregate. ISS has modified the prior case-by-case exemption for "new nominees" to exempt nominees who served for only a part of the fiscal year.

Independent Chair Proposals. ISS generally recommends a vote for shareholder proposals that would require an independent director to serve as board chair. ISS has modified its existing policy to codify the factors that will increase the likelihood that ISS will make a for recommendation on these proposals. These factors include:

- a board that has a majority of members who are not independent under ISS policies and/or the presence of non-independent directors on key board committees;
- a weak or poorly defined lead independent director role that fails to serve as an appropriate counterbalance to a combined CEO/chair role;
- 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;
- evidence that the board has failed to oversee and address material risks facing the company;
- a material governance failure; and
- evidence that the board has failed to intervene when management's interests are contrary to shareholders' interests.

Newly Public Companies – Problematic Governance and Capital Structures. For 2020, ISS has separated its voting policies for newly public companies that have multi-class capital structures with unequal voting rights from those with “problematic” charter and bylaw provisions.

Problematic Governance Structures at Newly Public Companies. For newly public companies, ISS will generally recommend voting against or withholding votes from directors individually, committee members, or the entire new board, other than new nominees (as defined below, who will be considered on a case-by-case basis), if the company or the board adopted charter or bylaw provisions that ISS considers to be materially adverse to shareholder rights before or in connection with the company’s initial public offering. These provisions include: a supermajority voting requirement to amend the charter or bylaws; a classified board structure; or other unspecified “egregious” factors. ISS will consider a reasonable sunset provision as a mitigating factor in issuing its recommendation. ISS will continue to consider voting recommendations on nominees on a case-by-case basis in subsequent years until the adverse governance provisions have been reversed or removed. A note to the ISS policy states that “newly public companies” generally include companies that emerge from bankruptcy, spin-offs, direct listings, and companies that complete a traditional initial public offering.

***Problematic Capital Structures at Newly Public Companies*.** Under its bifurcated policy on problematic structures at newly public companies, ISS will generally recommend voting against or withholding from all nominees, other than new nominees (who will be considered on a case-by-case basis), if the company or the board implemented a multi-class capital structure with unequal voting rights unless the multi-class structure is subject to a reasonable time-based sunset. ISS will assess reasonableness in light of the company’s lifespan, it’s post-IPO ownership structure and the board’s disclosed rationale for the sunset period, but no sunset period longer than seven years from the date of the company’s IPO will be considered reasonable by ISS. ISS will continue to recommend voting against or withholding from incumbent nominees in subsequent years until the problematic capital structure has been reversed or removed.

Clarification of “New Nominee” Exception. Some ISS voting policies provide exemptions that permit ISS to consider “new” director nominees on a case-by-case basis. ISS has modified its existing policy exemption for new nominees to clarify that the exemption applies to directors who are being presented for election by shareholders for the first time and have served on the board for less than one year. This change reflects the possibility that some director nominees, such as directors who were appointed to a classified board or directors of newly public companies, may have served on the board for a period of years before first being nominated for election by shareholders. ISS also modified the prior bright-line exception for nominees who had not already been elected by shareholders and joined the board after a problematic action had occurred; ISS will now apply this exemption on a case-by-case basis.

Evergreen Provisions in Equity and Other Incentive Plans. ISS voting recommendations on equity-based and other incentive compensation plans are generally made on a case-by-case basis, depending on plan features and equity grant practices using the ISS Equity Plan Scorecard (EPSC). Even if a plan would be eligible for a favorable recommendation based on its EPSC, ISS may issue a negative recommendation if any of a number of specific “egregious” overriding factors exist. For 2020, ISS has added the existence of an “evergreen” or automatic share replenishment feature to its list of overriding factors. This policy change is in response to the 2017 elimination of the former requirement under Section 162(m) of the Internal Revenue Code that required companies to seek shareholder approval of incentive plan metrics at least every five years in order for plan compensation to qualify for the performance-based pay exemption, which has resulted in a significant drop in the number of equity plans presented to shareholders for approval.

Share Repurchase Proposals. ISS generally recommends a for vote when companies seek shareholder approval of a share repurchase plan. ISS has modified its existing policy to clarify the circumstances in which it may issue an against recommendation. These include greenmail; the use of buybacks to inappropriately manipulate incentive compensation metrics; threats to the company's long-term viability (or bank's capitalization level); or other company-specific factors as warranted. ISS will also consider recommending an against vote on repurchases of shares directly from specified shareholders, depending on circumstances such as a premium to market price. ISS also clarified that this policy would apply not just to U.S.-incorporated companies but also to foreign-incorporated U.S. domestic issuers that are listed solely on U.S. exchanges, regardless of the company's country of organization.

Gender/Race/Ethnicity Pay Gap Reports. ISS generally makes voting recommendations on shareholder proposals seeking a report on the company's pay data by gender or the company's policies and goals to reduce any gender pay gap on a case-by-case basis, taking into account several company-specific factors. For 2020, ISS has added race and ethnicity to gender.

Non-Employee Director Pay. Under a policy introduced in 2018, ISS may issue a no or withhold recommendation for board nominees who approve or set non-employee director compensation. Because this ISS policy requires a recurring pattern of excessive non-employee compensation in two or more consecutive years without a compelling rationale, 2020 will be the first year in which ISS may issue a negative voting recommendation under this policy.

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