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Client Alert

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Proxy Advisory Firms Issue 2017 Voting Guidelines

Proxy advisory firms Institutional Shareholder Services (ISS) and Glass, Lewis & Co. (Glass Lewis) recently issued updated proxy voting guidelines for the upcoming 2017 proxy season. Notable updates were issued by one or both of ISS and Glass Lewis relating to the following:

- Governance and Capital Structure Following an IPO or Spin-Off
- Restricting Binding Shareholder Proposals
- "Over-Boarding"
- Board Evaluation and Refreshment
- Certain Compensation-Related Matters

The full text of the 2017 updated proxy voting guidelines published by ISS and Glass Lewis may be accessed here and here, respectively.

Governance and Capital Structure Following an IPO or Spin-Off

In its most recent guidance, ISS revised its policy on actions taken unilaterally by a company's board to amend the company's bylaws or charter in a manner that materially diminishes shareholders' rights or that could adversely impact shareholders.

The revised guidance expands the situations where ISS would generally issue recommendations to vote against or withhold votes from directors as a result of actions taken by the board prior to or in connection with a newly public company's IPO to include situations where the company implements a multi-class capital structure where the classes have unequal voting rights. The actual voting recommendations issued by ISS in response to any unilaterally adopted bylaw or charter amendment, or any multi-class capital structure containing classes with unequal voting rights, would take into account the following factors:

- The level of impairment of shareholders' rights;
- The disclosed rationale;
- The ability to change the governance structure (*e.g.*, limitations on shareholders' right to amend the bylaws or charter, or supermajority vote requirements to amend the bylaws or charter);

- The ability of shareholders to hold directors accountable through annual director elections, or whether the company has a classified board structure;
- Any reasonable sunset provision; and
- Any other relevant factors.

ISS's stated rationale for this change was the marked increase in the number of newly public companies completing IPOs with multi-class capital structures from prior years, rising to as high as 21 in 2014 from only 8 in 2006.

The revised ISS guidance also specifically rejects ISS's prior position that shareholder approval within 3 years following a newly public company's IPO would be sufficient to alleviate this adverse voting recommendation for any unilaterally adopted bylaw or charter provision or multi-class capital structure implemented prior to or in connection with the IPO. Instead, ISS will now require a reasonable sunset be included for any such provision or capital structure.

Under the revised ISS voting guidelines, IPO companies should generally assume that negative voting recommendations stemming from unilateral board actions or multi-class capital structures where the classes have unequal voting rights will apply for all future meetings unless a meaningful sunset provision is included. As a result, these revisions to ISS's voting guidelines have the potential to drastically alter the current governance practices implemented in connection with pending and future IPOs, particularly with respect to IPOs structured to accomplish specific tax objectives.

Glass Lewis also clarified its approach to corporate governance at newly public companies in its most recent guidance. While Glass Lewis generally believes that these companies should be allowed adequate time (*i.e.*, one year following an IPO) to fully comply with marketplace listing requirements and basic governance standards, Glass Lewis will also review the terms of the company's governing documents in order to determine whether shareholder rights are being severely restricted from the outset. Specific areas of governance that Glass Lewis will consider include:

- The adoption of anti-takeover provisions such as a poison pill or classified board;
- Supermajority voting requirements to amend governance documents;
- The presence of exclusive forum or fee-shifting provisions;
- Whether shareholders can call special meetings or act by written consent;
- The voting standard required for the election of directors;
- The ability of shareholders to remove directors without cause; and
- The presence of evergreen provisions in the company's equity compensation arrangements.

For companies that adopt an anti-takeover provision prior to an IPO, Glass Lewis will consider recommending a vote against the members of the board who served when such measures were adopted if the board did not commit to submit the anti-takeover provision to a shareholder vote at the company's first post-IPO shareholder meeting or did not provide a sound rationale or sunset provision for adoption of the measure in question.

Restricting Binding Shareholder Proposals

ISS introduced a new policy related to director accountability to address restrictions on "shareholders' fundamental right to amend the bylaws." Under the new policy, ISS will recommend a vote against or withhold votes from members of a company's governance committee if the company's charter or articles of incorporation impose undue restrictions on shareholders' ability to amend the bylaws. Such restrictions include outright prohibitions on the submission of binding shareholder proposals, or minimum share ownership thresholds or time holding requirements

in excess of SEC Rule 14a-8. While ISS particularly notes that certain states permit companies to restrict shareholders' right to submit a binding bylaw amendment in a company's charter, we believe that ISS may also extend the policy and recommend negative votes if a similar provision is included in a company's bylaws. The new policy effectively seeks to eliminate the use of the exclusion currently found in Rule 14a-8(i)(2) as it relates to certain binding shareholder proposals. Responses to ISS's recent survey update suggest that ISS is specifically targeting Maryland companies, particularly REITs, with this policy change.

"Over-Boarding"

The 2017 Glass Lewis updates codify the Glass Lewis policies previously announced in 2016 related to "over-boarding." Generally, Glass Lewis will recommend voting against any director who serves as an executive officer of a public company while serving on a total of more than two public company boards and against any other director who serves on more than five public company boards. The 2017 guidelines also clarify factors that Glass Lewis will consider in determining whether a director's service on an excessive number of boards warrants a negative recommendation, which include:

- The size and location of the other companies where the director serves - service on the board of multiple smaller companies in the same geographic area may be perceived more favorably than service on multiple large boards in diverse locations;
- The director's board duties at the companies in question;
- The director's tenure and attendance record at all companies; and
- The rationale disclosed for the director's continued service on multiple boards, including specialized knowledge of an industry, strategy or market, diversity of skills and background.

Glass Lewis may also consider the director's service on the board of any large privately-held companies in making its recommendation.

While ISS did not issue any additional guidance on over-boarding, ISS did indicate that it will implement its 2016 policy updates as scheduled and will generally recommend a vote against or a withhold vote for any director who serves as an executive officer of a public company while serving on a total of more than two public company boards and against any other director who serves on more than five public company boards.

Board Evaluation and Refreshment

The 2017 Glass Lewis updates clarify the approach Glass Lewis will take toward board evaluation, succession planning and refreshment. Under the 2017 guidelines, Glass Lewis will take a more holistic view focused on the assessment and alignment of director skills with company strategy. The 2017 policy guidelines emphasize the need to consider a director's unique skills, diverse perspectives and generation of new business strategies instead of focusing solely on director tenure and age. Glass Lewis noted that shareholders are better off monitoring the board's overall composition rather than imposing "inflexible rules" that do not necessarily correlate with future returns or benefits for shareholders. However, Glass Lewis cautioned companies that adopt term or age limits against waiving such limits. Generally, waivers of established limits will result in a recommendation against directors without sufficient explanation of the need for such waiver, such as consummation of a corporate transaction like a merger.

Certain Compensation-Related Matters

The 2017 ISS updates include two updates related to compensation matters for U.S. companies. ISS introduced an expanded framework for evaluation of stand-alone proposals seeking shareholder approval of compensation for non-employee directors and, in certain cases, non-employee director specific equity plan proposals. The expanded policy will consider, among other things, items such as the relative magnitude of director compensation compared to companies with a similar profile, the presence of problematic pay practices relating to director compensation, the mix of cash and equity or incentive-based compensation that a company's compensation program utilizes, any meaningful limits on director compensation and the quality of the company's disclosure surrounding its director compensation practices.

ISS also modified its equity plan scorecard for U.S. equity plans, adding a new factor to evaluate the payment of dividends on unvested awards. Under ISS's new policy, full credit will only be earned if the equity plan expressly prohibits the payment of dividends before the vesting of the underlying award (although accrual of dividends payable upon vesting is acceptable). ISS also modified its minimum vesting factor to clarify that an equity plan must specify a minimum vesting period of one year for all awards under the plan to receive full points.

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