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ISS, Glass Lewis Issue 2019 Policy Updates with Focus on Pay-for-Performance and Diversity

ISS' draft policies consider swapping GAAP metrics for EVA; meanwhile, Glass Lewis' final policies center on clawbacks, gross-ups, front loaded grants and more.

Proxy advisory firms ISS and Glass Lewis recently released their updated proxy voting policies for 2019. In ISS' case, the policies have been released in a draft form that is open for comments from interested stakeholders. However, experience with the ISS policy process strongly suggests that minimal changes, if any, will be made following the public comment process. Glass Lewis' method is less open, and their policies are adopted as published. This article summarizes the firms' changes for proxy voting in the United States. The full policy updates are located here for ISS and here for Glass Lewis.

ISS Draft Policy Updates

Pay-for-Performance: For 2019, ISS is proposing to replace GAAP financial metrics with Economic Value Added (EVA) metrics in the second stage of ISS' quantitative pay-for-performance screening. The financial metrics that could potentially be replaced have been in place for two years and were only directly factored into vote recommendations in the past year. If formalized, the change will be effective immediately for annual meetings beginning February 1, 2019. This means that there will be no phase-in period like ISS used when it adopted the GAAP financial metrics two years ago. While the adoption of EVA for the secondary screen will likely be final, ISS is additionally seeking comments on two questions: 1) should TSR still be used as the primary metric for performance, and 2) should GAAP metrics still be presented for informational purposes?

Board Gender Diversity: ISS is proposing to issue negative recommendations on members of a board with no female representation. This proposed policy would take effect in 2020, following a one-year grace period, and could be especially impactful for the U.S. market. According to ISS, nearly 500 companies in the Russell 3000 and S&P 1500 currently have no women on the board. ISS seeks comment on potential mitigating circumstances and encourages directors to target boards lacking gender diversity. We note that Glass Lewis' corresponding policy, discussed below, contains some exceptions that may also be adopted into ISS policy.

Glass Lewis Compensation-Related Updates

Excise Tax Gross-Ups: Consistent with ISS' historical practice, Glass Lewis will begin flagging companies that adopt excise tax gross-ups in 2019. While this has been previously noted in Glass Lewis' reports, the practice will now be considered when recommending votes on compensation committee directors. Like ISS, it appears that Glass Lewis will automatically recommend against members of the compensation committee when excise tax gross-ups are adopted.

Grants of Front-Loaded Awards: With regards to say-on-pay recommendations, when companies grant front-loaded awards, Glass Lewis will now evaluate whether the company has made an affirmative commitment to not grant additional equity to the recipient for a period of time (in addition to the size and circumstances for the awards). In the event that Glass Lewis determines such a commitment has not been met, it will consider negative recommendations upon review of the rationale for the subsequent grant in relation to its prior commitment.

Contractual Payments and Arrangements: When evaluating the size of both severance and sign-on arrangements for say-on-pay recommendations, Glass Lewis will consider both the design of the program, as well as the quantum relative to the executive's regular target compensation level. The firm might also consider sums paid to other executives (including the recipient's predecessor, where applicable) in evaluating the appropriateness of such an arrangement.

Disclosure of Compensation (for Smaller Reporting Companies): When analyzing the performance of a board's compensation committee, Glass Lewis will consider the impact of materially decreased CD&A disclosure when formulating recommendations. The firm may also recommend against members of the committee where a reduction in disclosure substantially impacts shareholders' ability to make an informed assessment of the company's executive pay practices. In sum, this policy appears to be an overall evaluation of the companies' use of scaled disclosure.

Recoupment Provisions (Clawbacks): In the past, Glass Lewis' evaluation of clawback policies has simply focused on whether the company maintains (and discloses) the existence of a policy. Glass Lewis' evaluation going forward will be against the requirements of the Dodd-Frank Act policy (notably, its requirement that clawbacks be triggered upon a material restatement), which is more prescriptive than many companies' voluntarily-adopted policies.

Glass Lewis Governance-Related Updates

Board Gender Diversity: Glass Lewis' board gender diversity policy (adopted in 2017 and effective for 2019) generally recommends votes against the chair of the nominating committee if there are no female directors on the board. However, the policy will consider a company's disclosure of its diversity considerations and may refrain from recommending shareholders vote against directors of companies outside the Russell 3000 index, or when boards have provided a sufficient rationale for not having any female board members. According to Glass Lewis, this may include, but is not limited to, a disclosed timetable for addressing the lack of diversity on the board and any notable restrictions on the board's composition, such as director nomination agreements with significant investors.

Conflicting and Excluded Proposals: Glass Lewis adopted a policy concerning conflicting and excluded shareholder proposals, under which the firm will generally recommend votes in favor of the shareholder proposal and against the corresponding management proposal. For example, if a shareholder proposal on shareholders' right to call special meetings has a lower vote threshold than a management proposal, Glass Lewis will support the shareholder proposal. If a company has excluded a shareholder proposal from the ballot based on SEC noaction relief, Glass Lewis will recommend against the management proposal and against the members of the nominating and governance committee.

Environmental and Social Risk Oversight: In instances where companies have not properly managed or mitigated environmental or social risks to the detriment of shareholder value, or when such mismanagement has threatened shareholder value, Glass Lewis may consider recommending that shareholders vote against members of the board who are responsible for oversight of environmental and social risks. In the absence of explicit board oversight of these issues, Glass Lewis may recommend that shareholders vote against members of the audit committee. However, it's not clear how Glass Lewis will determine what constitutes a "material oversight" that will trigger negative recommendations.

Auditor Ratification: Glass Lewis has codified additional factors (bringing the total to nine factors) to consider when reviewing auditor ratification proposals. These include the auditor's tenure, a pattern of inaccurate audits, and any ongoing litigation or significant controversies that call into question an auditor's effectiveness. In limited cases, these factors may contribute to a recommendation against auditor ratification.

Virtual-Only Meetings: Glass Lewis' policy regarding virtual-only shareholder meetings, announced in November 2017, will take effect for meetings held after January 1, 2019. Under this new policy, for companies that opt to hold their annual shareholder meeting exclusively by virtual means, Glass Lewis will examine the company's disclosure of its virtual meeting procedures and may recommend voting against members of the governance committee if it does not provide disclosure that assures shareholders will be afforded the same rights and opportunities to participate as they would at an in-person meeting (most notably the opportunity to ask questions during the meeting).

Next Steps

These policy updates contain numerous provisions that will impact boards of directors and executives. We will track their impact as the 2019 proxy season unfolds and bring our clients updates. We will also monitor whether ISS makes any modifications to their proposed policy changes once they publish their final updates later this month.

If you have any questions about these policy updates or want to speak to a member of our consulting team about related compensation and governance issues, please write to consulting@radford.com.

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