ISS Releases 2017 Policy Survey Results

ISS has released its "2017 Policy Survey" results, completing one of the initial steps in its annual formulation of new and updated voting guidelines. ISS will release its preliminary 2017 policy updates in late October and, after providing a brief comment period for issuers and others, will finalize new guidelines in mid-November. ISS policy updates will be effective for shareholder meetings that occur after February 1, 2017.

Policy Survey Respondents

ISS received 439 responses to this year's survey. 270 or 61% of the responses were from corporate issuers and 120 or 27% of the responses were from institutional investors. Notably among investor responses, 73 responses were from asset managers or investment managers, 16 were from mutual funds and 15 were from government or state sponsored pension funds.

According to ISS, 33% or 40 of the 120 total investor responses were from shareholders with assets under management or assets owned of greater than $100 Billion. These 40 largest respondents include the largest investment firms, who populate the top of many issuers shareholder lists. Another 25% of respondents or approximately 30 investor responses, were from investors with $10 Billion to $100 Billion in assets under management or owned. The remainder were smaller investors. ISS does not provide the percentage of responses to their survey within the asset size categories they identify.

Topics & ISS Findings

Metrics Used in Pay for Performance Assessments

The survey question response that is likely to lead to the most significant policy change in 2017 relates to the initial quantitative pay for performance screen that ISS uses as an integral part of its say on pay recommendations. ISS currently uses total shareholder returns over various time periods, both absolute and relative to ISS assigned peers, to identify companies with potential pay for performance conflicts.

Respondents were asked whether additional financial metrics would be useful in the initial quantitative screen. As has been the case in some recent investor surveys, investors overwhelmingly supported the inclusion of various operational metrics as part of the quantitative evaluation in a pay for performance analysis. While not quite as enthusiastic as investor respondents, non-investor responses, which were dominated by the 270 corporate issuers, also overwhelmingly supported the inclusion of financial metrics.

These are the metrics for inclusion each side supported:

Financial Metric	Investor	Non-investor
Revenue metrics (such as total revenue or revenue growth)	18%	24%
Earnings metrics (such as EPS or EBITDA)	26%	38%
Return metrics (such as ROA or ROE)	35%	18%
Return on investment metrics (such as ROIC)	47%	23%
Cash flow metrics (such as OCF or FFO)	25%	20%
Economic profit metrics	22%	9%
Other	16%	10%

Based on these and other survey results it seems likely that a future ISS pay for performance screen will factor operational performance into the model. The devil would be in its implementation details of course. Even if ISS updates its quantitative screen, how it would actually function wouldn't be known until there are results to analyze in the early part of proxy season.

Director Tenure / Board Refreshment

As was the case in 2015, ISS once again has surveyed lengthy director tenure. Based on the premise that "lengthy director tenure has been identified by commentators as a potential obstacle to adding new skill sets and diversity to boards and a potential risk to the independence of long-serving directors", survey respondents were asked, "*Which of the following tenure factors would prompt your organization to consider that there may be concerns with a board's nominating and refreshment processes?*"

- 53 percent of investor responses identified an absence of newly-appointed independent directors in recent years (e.g. 5 years) as indicative of a problem,
- 51 percent flagged lengthy average tenure (10-15 years) as problematic,
- 68 percent responded that a high proportion of directors with long tenure (e.g. 75% of board having tenure of more than 10 years) is cause for concern.

Since ISS' Governance Quickscore already considers a tenure of more than nine years as potentially compromising director independence, it wouldn't surprise us if ISS introduced a guideline that related to long-term average director tenure. Our best guess would be that any new ISS guideline would only target outliers.

Opting out of provisions of Maryland Law

In what would have a significant impact on numerous boards of Maryland incorporated REIT's, ISS appears to be contemplating a new guideline that, based on investor survey responses alone, would alter the governance landscape. For several reasons, Maryland has developed into the legal domicile to more than 80% of all publicly traded REITs in the U.S. But there are several provisions in Maryland law that most REIT's have adopted that many shareholders, perhaps motivated by some recent real-world examples of their corporate use, especially as it relates to MUTA, are increasingly finding objectionable.

These provisions include:

- Directors the ability to amend the bylaws without shareholder approval
- Directors the ability to increase the number of authorized shares without shareholder approval

18% of investor respondents supported an ISS policy that would recommend an against vote on at least one director, the governance chair. However, 34% of the respondents supported a policy that would recommend against the entire governance committee and 25% supported a policy that would result in a recommendation against the entire board. With 77% of the investor responses in support of a strong policy, and most suggesting repercussions for an entire committee, companies should expect these provisions to come further under the spotlight in 2017.

MUTA

The Maryland Unsolicited Takeover Act (MUTA) also allows a board to unilaterally make changes, without shareholder approval, to a company's capital structure and charter/bylaws that "provide significant anti-takeover protections to these corporations." ISS stated that these include, but are not limited to:

- the ability to re-classify a board;
- the exclusive right to set the number of directors;
- limiting shareholders' ability to call special meetings to a threshold of at least a majority of shares

Similarly, 20% of investor respondents supported a policy against the governance chair, 31% against the governance committee and 27% against the full board. With 78% of the investor responses supporting a strong policy, companies that have not opted out of these provisions, should expect ISS to adopt a policy that targets at least certain members of the board with negative recommendations either next year or in 2018.

It's possible that ISS would hold off in 2017 on applying a new guideline with such drastic immediate implications for so many directors. While the investor survey responses send a strong message, ISS may provide issuers a year to voluntarily comply with a new guideline before taking the step of issuing what would likely be numerous negative recommendations against directors. This was their approach on certain new overboarding guidelines last year. That is not to say that shareholders themselves won't take action in 2017.

Within a few years or earlier, we think it is highly likely that companies containing these bylaw/charter provisions will be under such pressure to relinquish them that most probably will. Indeed, companies are already being targeted with shareholder proposals to remove some of these provisions, (an issue ISS supports) and as the survey results demonstrate, shareholders appear ready to accelerate this issue.

Say on Pay Frequency

It's now been six years since Say on Pay was introduced in corporate America and, as Dodd-Frank mandated, issuers must put the frequency of their Say on Pay proposal to a vote of shareholders at least once every six years. 2017 is that year for most issuers. 66% of investor respondents and 42% of non-investor respondents supported annual Say on Pay votes. While some observers may be surprised that one-third of investor respondents didn't support annual votes, we don't believe there is any reason to expect a change in ISS policy moving away from annual votes. From the corporate perspective the annual say on pay proposal does often serve, at least initially, to shield the compensation committee from receiving significant negative votes when shareholders disapprove of a company's pay practices. Without an annual Say on Pay proposal directors on compensation committees are more vulnerable to negative votes.

Overboarding for Executive Chairman

Survey respondents were asked which "overboarding" standard should apply "to an executive chairman who is not also the company's CEO?"; should it be the same standard that is applied to a sitting CEO (no more than three total boards) or should it be the standard applied to a non-executive director (no more than five total boards)?"

Investor and non-investor responses were inverted with a 64/36 split from investors in favor of the more stringent CEO standard, with a 62/38 split in favor of the more lenient non-executive standard from non-investors. As you may recall, the non-executive standard was reduced from 6 to 5 last year. BlackRock guidelines currently limit this number to 4.

Multi-class Structure for IPO Companies

Respondents were asked whether "ISS should consider recommending votes against directors at companies that go public, or emerge from bankruptcy, with a capital structure that includes multiple classes of stock with unequal voting rights".

57 percent of investor respondents supported negative recommendations for such companies, while 19 percent opposed them, and 24 percent opposed negative recommendations as long as there is a sunset provision on the unequal voting rights. A majority of non-investor respondents apparently supported a negative recommendation when there was no sunset provision to the unequal voting rights. Sounds to us like a new policy.

Executive Pay Assessments (Cross-Border implications)

As a result of the number of corporate inversions, there are a growing number of U.S. companies that are now listed in the United States but domiciled in Europe or elsewhere. As such, these companies are obligated to hold three separate votes on executive compensation, such as the "backward-looking advisory votes on executive compensation mandated by U.S. and U.K. law, and the forward-looking binding vote on remuneration policy required by U.K. law." According to ISS, such cross-border listings presents challenges when considering which set of best practices should apply.

A majority of investors (65%) and non-investors (59%) said vote recommendations for the compensation proposals should be aligned, so as to not produce inconsistent evaluations of a single pay structure. Following that, only a small minority of investor (27%) and non-investor (28%) thought it acceptable to have opposing vote recommendations for the compensation proposals if each reflects the underlying policy of the relevant country. This sounds like good news for U.S. listed companies that are domiciled elsewhere. But let's see how it plays out.

Conclusion

We'll issue another update once ISS issues their preliminary guidelines for 2017 in late October. In the meantime, we can always be reached at (212) 257-1311 or at info@saratogaproxy.com.