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Dealing with Proxy Advisers in 2013: Peer Groups and More

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The two leading proxy advisers, Institutional Shareholder Services Inc. ("ISS") and Glass Lewis & Co., LLC ("Glass Lewis"), have recently announced updates to their proxy voting policies that will apply to the upcoming 2013 proxy season (the "ISS Update" and the "GL Update," respectively). While ISS is generally regarded as the more influential of the two, many large institutional investors subscribe to both advisers. Also, some investors are more willing to depart from an ISS recommendation if Glass Lewis takes a different position. Accordingly, we advise becoming familiar with both advisers' policies. We also recommend that companies identify the extent to which their major shareholders rely on ISS and/or Glass Lewis.

The ISS Update, which revises ISS's Proxy Voting Guidelines, will apply to ISS recommendations for shareholder meetings held on or after February 1, 2013. The ISS Update incorporates, to some extent, the results of ISS's 2012-2013 Policy Survey (the "Policy Survey"), released in September 2012, in which ISS gathered feedback from both institutional investors and issuers regarding the importance of various corporate governance topics. (Glass Lewis does not disclose a similar survey.)

Both updates and the Policy Survey highlight the issues viewed as important by ISS, Glass Lewis and many institutional investors. Rather than summarize every policy change by both ISS and Glass Lewis, we discuss below those we believe are most important and, where relevant, relate them to the results of the Policy Survey. In particular, as discussed further below, ISS has announced that *December 21, 2012* is the deadline for submitting peer group changes that an issuer wants ISS to consider in constructing ISS's peer group for CEO compensation.

1. Peer Groups.

The composition of peer groups is critical to pay/performance comparability. Despite the issues that companies have repeatedly raised over ISS-selected peer groups, very few respondents in the Policy Survey wanted ISS to abandon them altogether. Instead, respondents preferred that ISS compare companies against both ISS's peer group *and* the company's peer group. The ISS Update incorporates these preferences, albeit indirectly. ISS will look at the industries of the company-selected peers and prioritize those industries in selecting peers. While this change will allow a company to influence its ISS peer group and it will likely result in fewer outliers (in the company's view) in the ISS peer group, it will not ensure that the Proxy Voting Report will contain the company-selected peers, even though that was the preference expressed by respondents in the Policy Survey.

Importantly, *if a company is planning on making changes to its peer group in its 2013 proxy statement, it may submit the revised peer group to ISS until December 21, 2012*, to ensure that the revised peer group is considered by ISS. Companies that are planning on revising their peer group should note that respondents in the Policy Survey stated that peers should be in the same revenue range, and in the same Global Industry Classification Standard group, as the company. Additionally, respondents preferred that peer groups based on revenue should be constructed so that the company is at or near the median of the group.

2. Pledging of Company Stock.

After several high-profile incidents in recent years involving directors pledging stock, stock pledging has become an increasingly important corporate governance topic. In the Policy Survey, approximately one-half of institutional investors replied that *any* pledging of stock by directors is "significantly problematic" and an additional 37% of respondents stated that pledging a large amount of stock raises such concerns. The ISS Update incorporates these preferences. Accordingly, excessive pledged stock may now constitute a "failure of risk oversight" that warrants a recommendation by ISS against the director who pledged the stock or, in extreme circumstances, against other directors as well.

If a company discloses that it has a director or executive who has pledged stock, ISS, when making its voting recommendation, will examine the magnitude of the pledge and consider whether the company has taken and disclosed any of the following mitigating steps:

- Adoption of a policy that prohibits future pledging;
- Reduction over time of the amount of pledged stock; and
- Verification that the director or executive in question still meets stock ownership guidelines without including the pledged stock.

It may be prudent for a company to consider whether its directors have pledged stock when evaluating the company's overall corporate governance profile. If a director has pledged stock, it may be worthwhile to consider implementing some of the mitigating actions discussed above. Companies may also wish to consider adopting an anti-pledging policy, if they do not already have one, to discourage directors or executives from pledging their stock in the future. The GL Update does not mention pledging.

3. Hedging.

The ISS Update came out strongly against hedging. According to ISS, "[a]ny amount of hedging will be considered a problematic practice warranting a negative voting recommendation." However, it is unclear whether ISS is referring to any hedging by directors, executives or employees, or just hedging by directors. Companies should consider adopting a policy, if they do not already have one, prohibiting any hedging activities by directors, executives and employees. The GL Update does not mention hedging.

4. Majority-Supported Shareholder Proposals and Significant Shareholder Votes.

In the past, ISS would recommend voting against an entire board if the company failed to implement a proposal that received the support of either:

- A majority of *votes entitled to be cast* the previous year; or

- A majority of *votes cast* the previous year *and* one of the two years before the previous year.

Beginning in 2014, ISS will recommend voting against the entire board if the board fails to implement a proposal that receives the support of a majority of *votes cast* in the previous year. This will truly be a “one-strike” policy. We find this policy to be very worrisome because it would result in a recommendation against the board for not implementing any proposal – even a social, political or environmental proposal – that received the approval of a mere majority of the *votes cast* rather than votes *entitled to be cast*. This issue is particularly troublesome for the many companies that, under pressure from ISS and Glass Lewis, among others, have adopted majority voting, because an adverse ISS recommendation on directors is more likely to trigger a failed election and, with respect to incumbent nominees, the consequent required offer of resignation by the directors who voted not to implement the proposal.

The GL Update provides that whenever more than 25% of votes cast are cast against a recommendation by management (including management proposals and director nominees), Glass Lewis will evaluate the company’s response, including (depending upon the issue) any board action, updates to a company’s business policy and revisions to governance documents or compensation programs. Glass Lewis has stated that it “believes that any time 25% or more of shareholders vote against the recommendation of management, the board should demonstrate some level of engagement and responsiveness to address the shareholder concerns.” This is an unwise position as shareholders often vote for or against director nominees or management proposals for reasons that may not be shared by other holders.

This new 25% Glass Lewis threshold for management recommendations is similar to ISS’s policy on say-on-pay proposals. ISS has previously stated that if any say-on-pay proposal receives the affirmative vote of less than 70% of votes cast, ISS will conduct a more thorough evaluation of the company’s response to the vote and any changes to its compensation program when formulating its voting recommendations for future director nominees and say-on-pay proposals. These positions are startling because while both advisers place great emphasis on the importance of a shareholder proposal that receives majority support, each then minimizes the importance of “only” 70% or 75% support for a management proposal (or management-supported compensation structure).

For all these reasons, we recommend that boards pay close attention to the levels of support and opposition received on all nominees and proposals.

5. Lead Director.

According to the Policy Survey, if a company has a proposal in its proxy statement to separate the roles of chairman and CEO, whether the company has already appointed a lead director is the single most important factor that institutional investors will consider when determining how to vote. We believe that companies without a split chairman and CEO should consider preparing for this type of proposal because, in our experience it is becoming increasingly common. In fact, separating the chairman and CEO may be the next big thing for corporate governance activists, once the current movement for majority voting in the election of the directors winds down.

In addition to considering appointing a lead director and disclosing it in their proxy statements, we recommend that companies without a separate chairman and CEO consider adopting a lead director charter setting forth the duties and responsibilities of the lead director. In our experience, a lead director charter is helpful in explaining why a separate chairman and CEO are not necessary for the company.

6. Pay for Performance.

According to the Policy Survey, over 80% of institutional investors stated they were either "very likely" or "somewhat likely" to consider performance metrics other than total shareholder return ("TSR") when evaluating a company's management say-on-pay vote. Thus, despite ISS's focus on this one metric, it continues to be appropriate for a company to discuss a wide range of performance metrics in its proxy statement. A slavish devotion solely to TSR is not necessary.

In reviewing this material, it should be borne in mind that, as always, each director should act in what he or she reasonably believes to be in the best interests of the company, not according to what one or more proxy advisers think is good corporate governance.

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As always, we and our colleagues are available to discuss these matters.

Jim Hanks
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