SULLIVAN & CROMWELL LLP

2019 Proxy Season Review: Part 2

ISS Negative Recommendations Against Directors

July 25, 2019

ISS recommendations continue to correlate with lower director support levels:

- Directors average 97% shareholder support with ISS in favor and 79% if not (level with 2018), although almost all directors win over 50% shareholder support
- S&P 500 directors identified for excessive non-audit fees or poor attendance receive the lowest average shareholder support (55% and 63%, respectively)
- Outside of the S&P 500, Russell 3000 directors receive the lowest average shareholder support for non-responsiveness to shareholder concerns or excessive non-audit fees (58% and 60%, respectively)

ISS focus areas diverge between S&P 500 and broader Russell 3000:

- No S&P 500 directors identified for non-responsiveness (either to low say-on-pay vote or other shareholder concerns), poison pill or unilateral action, although a meaningful number of Russell 3000 directors was cited for each, as broader Russell 3000 falls behind in adopting some corporate standards
- Most common negative recommendation among Russell 3000 relates to adverse governance provisions at newly public companies (369 outside S&P 500, compared to three within)

ISS launches 2019 policy survey, including questions regarding overboarding, independent chair, board diversity and climate disclosure

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INTRODUCTION

Our annual proxy season review memo summarizes significant developments relating to the 2019 U.S. annual meeting proxy season. This year our review comprises three parts: Rule 14a-8 shareholder proposals submitted and voted, ISS negative recommendations and compensation-related matters. This is Part 2. Part 1, which focuses on Rule 14a-8 shareholder proposals, was published on July 12, 2019, and is available at Proxy Season Review Part 1. We expect to issue Part 3 later this month. Details regarding our annual webinar to discuss 2019 proxy season developments will be disseminated later this summer.

The ISS negative recommendations against directors we discuss are those issued against directors who were up for election at uncontested annual meetings of Russell 3000 and S&P 500 companies this year through June 1, 2019. For convenience, we refer to recommendations against "directors" rather than "nominees." The vast majority of ISS negative recommendations are against incumbent directors, since ISS generally will not deem new nominees responsible for past board actions (though new nominees could receive negative recommendations due to overboarding or independence concerns).

The data on ISS negative recommendations against directors derives from information provided by ISS summarizing the rationales with respect to the negative director recommendations issued by ISS at annual meetings of Russell 3000 and S&P 500 companies through June 1, 2019. We have supplemented the ISS data with information from public filings and statements by issuers.

For a discussion of U.S. proxy contests and other shareholder activist campaigns, see our publication, dated March 14, 2019, entitled "Review and Analysis of 2018 U.S. Shareholder Activism."

More generally, for a comprehensive discussion of U.S. public company governance, disclosure and compensation, see the *Public Company Deskbook: Complying with Federal Governance and Disclosure Requirements* (Practising Law Institute) by our colleagues Bob Buckholz and Marc Trevino, available at 1-800-260-4754 (1-212-824-5700 from outside the United States) or http://www.pli.edu.

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PART 2. ANALYSIS OF ISS NEGATIVE RECOMMENDATIONS AGAINST DIRECTORS

ISS issued negative recommendations against 9% of directors in uncontested elections for meetings through June 1, 2019 among the Russell 3000, totaling about 1,100 directors and affecting 411 companies (in each case, generally consistent with both the percentage and total number during the same period in 2018). The average level of voter support was 79% on an ISS recommendation against a director, relative to 97% if ISS recommends for a director, consistent with 2018. Recommendations appear to resonate most with shareholder sentiment, in the areas of non-responsiveness to shareholder concerns and excessive non-audit fees, both of which result in meaningfully lower average shareholder support and both of which have become more impactful for the past several years.

It remains relatively uncommon for directors to receive less-than-majority support, with only about 2% of directors who received negative recommendations having more "against" votes than "for" votes in 2019 and only about 7% receiving less than 60% support. The percentage was relatively significant, however, for lack of responsiveness to shareholder concerns (25%) and insufficient responsiveness to say-on-pay proposals (10%).

Looking at S&P 500 companies separately, ISS issued negative recommendations against 2% of directors (or just over 63 directors), affecting 29 companies (in each case, also generally consistent with both the percentage and total number during the same period in 2018). Only two of these directors received less-than-majority support (one of the two received a negative recommendation for failure to attend 75% of the board and committee meetings, and the other as a result of service on the compensation committee of a company where the CEO was perceived to have an insufficiently performance-based compensation package and guaranteed minimum long-term equity awards).

The most common rationales for a negative recommendation from ISS were generally the same as for the Russell 3000 generally and for the smaller group of U.S. S&P 500 companies. Independence issues (15 at S&P 500 compared to 253 at Russell 3000), compensation issues (16 at S&P 500 compared to 168 at Russell 3000), and shareholder inability to amend bylaws (15 at S&P 500 compared to 125 at Russell 3000) each represented a significant portion of the total number of negative recommendations at both S&P 500 and Russell 3000 companies. On the other hand, adverse governance provisions at newly public companies not subject to a sunset (three at S&P 500 compared to 369 at Russell 3000), absence of a formal nominating committee (two at S&P 500 compared to 114 at Russell 3000), poison pill issues (none at S&P 500 compared to 47 at Russell 3000) and poor attendance at meetings (three at S&P 500 compared to 63 at Russell 3000) were among the top rationales for negative recommendations at Russell 3000 companies but rarely lead to negative recommendations at S&P 500 companies.

This was the first year in which we saw ISS issue no negative recommendations for S&P 500 companies in some categories, while issuing a substantial number of negative recommendations for Russell 3000 companies. This trend likely reflects a coalescing of larger companies around certain corporate standards, while the broader Russell 3000 lags behind in the implementation of these standards.

The following table summarizes the frequency of ISS negative recommendations, the resulting shareholder vote and the number of directors receiving less-than-majority support during 2019 for U.S. Russell 3000 and S&P 500 companies, broken down by the rationale given by ISS for the negative recommendation.[1]

	2019 ISS Director "Withhold" or "Against" Recommendations (U.S. Russell 3000 Companies)			***2019 ISS Director "Withhold" or "Against" Recommendations (U.S. S&P 500 Companies)***		
	Number of Directors	***Average Shareholder Vote (% of Votes Cast)***	***Directors Receiving <50% of Votes Cast***	***Number of Directors***	***Average Shareholder Vote (% of Votes Cast)***	***Directors Receiving <50% of Votes Cast***
Newly public company with adverse governance provisions not subject to a sunset	369	84%	4	3	65%	0
Board independence (non-independent directors on key committees or failure to maintain a majority independent board)	253	87%	3	15	83%	0
Shareholder inability to amend bylaws	125	75%	3	15	77%	0
Lack of formal nominating committee	114	90%	1	2	90%	0
Poor attendance at board and committee meetings (<75%)	63	78%	4	3	63%	1
Compensation issues:						
Lack of responsiveness to low say-on-pay vote	63	68%	6	0	-	-
Other compensation issues (with no 2019 say-on-pay vote)	14	80%	0	0	-	-
Other compensation issues (with 2019 say-on-pay vote)	91	84%	0	16	84%	1
Poison pill issues (*e.g.*, failing to obtain shareholder approval)	47	82%	3	0	-	-
Failure of risk oversight due to pledging of shares by executives	37	85%	0	11	88%	0
Lack of responsiveness to shareholder concerns (*e.g.*, failure to implement a successful shareholder proposal)	28	58%	7	0	-	-
Overboarding	26	69%	0	4	70%	0
Unilateral action by the board that reduces shareholder rights	12	71%	1	0	-	-
Failure to address material weakness in internal controls	4	80%	0	1	70%	0
Excessive non-audit fees paid to auditors, or failure to disclose a breakdown of fees	4	60%	0	1	55%	0
Failure to opt out of amendment to Indiana law resulting in classified board	3	80%	0	3	77%	0
General performance or oversight concern	12	83%	0	4	71%	0

[1] There is some overlap in this table because some directors received negative recommendations for more than one reason. In this table, we present data for Russell 3000 companies, excluding the impact of the S&P 500 companies.

A. NEWLY PUBLIC COMPANY WITH ADVERSE GOVERNANCE PROVISIONS

The most common basis for ISS negative recommendations for Russell 3000 companies related to adverse governance provisions at newly public companies not subject to a sunset, with the percentage of directors in this category representing approximately 34% of the total number of Russell 3000 directors who received a negative recommendation (or approximately 35% excluding S&P 500 directors). S&P 500 directors in this category, on the other hand, represented only approximately 5% of the total number of S&P 500 directors who received a negative recommendation in 2019, with only three directors receiving a negative recommendation for this reason.

As confirmed in its policy updates for meetings on or after February 1, 2019,[2] ISS will generally vote against or withhold from individual directors, committee members or the entire board (except new nominees, who are considered case-by-case) if, prior to or in connection with the company's initial public offering, the company or its board adopted bylaw or charter provisions materially adverse to shareholder rights, or implemented a multi-class capital structure in which the classes have unequal voting rights. The factors that ISS will consider include:

- the level of impairment of shareholders' rights;
- the disclosed rationale;
- the ability of shareholders to change the governance structure (*e.g.*, limitations on shareholders' rights 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; and
- any reasonable sunset provision.

In 2019, in the vast majority of cases, the reason for the negative recommendation was a failure to remove, or subject to a reasonable sunset, dual class voting rights, supermajority voting requirements and/or a classified board structure.

Among the Russell 3000, average support level for directors in this category was 84%, and only four out of the 369 directors in this category received less-than-majority support (among the S&P 500, average support level for directors in this category was meaningfully lower at 65%, but none of the three directors in this category received less-than-majority support). Based on these results, directors at companies (in particular large-cap companies) that have recently gone public with dual class stock, classified boards and/or supermajority voting provisions are likely to face reduced support levels but do not face a significant risk of

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[2] *See* ISS, United States Proxy Voting Guidelines: Benchmark Policy Recommendations (Dec. 6, 2019), *available at* https://www.issgovernance.com/file/policy/active/americas/US-Voting-Guidelines.pdf.

receiving less-than-majority support. The relatively low impact on voting results may be due, in part, to the fact that newly public companies are more likely to have a large portion of shares held by insiders.

In past years, when directors received less-than-majority support in this category, ISS has identified multiple criteria that warranted a negative recommendation, including lack of responsiveness to shareholder concerns, failure to attend 75% of the board and committee meetings, failure to maintain independence on certain committees or unilateral action by the board. This year, although ISS identified more than one rationale with respect to two of the four directors that received less-than-majority support (lack of responsiveness to shareholder concerns, insufficient responsiveness to low say-on-pay vote, unilateral board action and/or failure to attend 75% of the board and committee meetings), for the remaining two directors, adverse governance provisions were the only basis ISS identified for its negative recommendation.

B. BOARD INDEPENDENCE

Independence-related considerations had been the most common basis for a negative ISS recommendation against a director in 2016 through 2018. This year this category fell to second place overall (representing 24% of the total number of Russell 3000 directors who received a negative recommendation), although it remained as one of the most frequent bases for a negative recommendation among the S&P 500 (also representing 24% of the total number of S&P 500 directors who received a negative recommendation).

ISS will recommend against directors that it deems non-independent if, among other things, they serve on the audit, compensation or nominating committee, or if the board is not made up of a majority of independent directors under the ISS independence standards. The ISS standards are, in some circumstances, more stringent than the company's own independence policies or applicable stock exchange rules. Even where the ISS standards overlap with the independence standards of the New York Stock Exchange and/or NASDAQ, they might be more stringent than the independence requirements applicable to the company because it is not listed on the relevant stock exchange.

Outside of the S&P 500, Russell 3000 directors in this category received average shareholder support of 87% of votes cast in 2019, and only three out of 253 such directors received less-than-majority support (among the S&P 500, average support level for directors in this category was comparable at 83%; none of the 15 directors in this category received less-than-majority support). This data, combined with this year's high frequency of independent chair shareholder proposals as discussed in Part 1 of our annual proxy season review memo, suggests that shareholders are focused on independent board oversight but do not necessarily view a violation of ISS's strict independence standards as a significant concern.

Given the varying independence definitions used by proxy advisory firms and certain institutional investors, companies may wish to consider including in the board's annual independence review process some discussion of whether any particular relationships are expected to trigger adverse recommendations or votes from proxy advisory firms or from the company's significant shareholders. Boards are, of course, in no way required to comply with the director independence definitions of these parties, but an assessment of perceived independence issues under these definitions can help the company identify and prepare for potential adverse votes from shareholders.

C. SHAREHOLDER INABILITY TO AMEND BYLAWS

Since 2017, ISS has applied a policy of recommending against members of the governance committee of companies where shareholders do not have the right to amend the bylaws. The number of directors receiving a negative recommendation on this basis has been on the decline since the policy was first implemented in the 2017 proxy season. This year the directors in this category represented 13% of the total number of Russell 3000 directors who received a negative recommendation (or 12% excluding S&P 500 directors) and 24% of S&P 500 directors who received a negative recommendation. Among S&P 500 companies, inability to amend bylaws was tied with independence considerations as one of the two most common bases for a negative recommendation this year.

Only a handful of states permit companies to deny shareholders the right to amend the bylaws. Of the 51 companies whose directors received negative recommendations on this basis, 37 companies are organized in Maryland (almost all of which are real estate investment trusts), eight in Indiana, two in Texas, and one in each of Delaware, Florida, Massachusetts and Nevada.

Of the 125 Russell 3000 directors who received a negative recommendation on this basis in 2019, three received less-than-majority support, and average shareholder support for directors in this category remained level with 2018 at 75%. Of the 15 S&P 500 directors who received negative recommendations on this basis in 2019, none received less-than-majority support, and average shareholder support was 77%, level with 2018.

ISS's stated policy is to vote against directors on the governance committee if the company's governing documents impose undue restrictions on shareholders' ability to amend the bylaws, including, outright prohibition on bylaw submissions, as wells as ownership requirements or time-holding requirements in excess of the restrictions put forth in Rule 14a-8. Despite including questions regarding shareholder direct amendment to the bylaws in ISS's annual policy survey, the policy has remained unchanged since its adoption.

ISS's recent recommendation regarding AvalonBay illustrates how ISS continued to apply its policy in 2019. In November of 2017, AvalonBay amended its bylaws to permit shareholders to directly amend the bylaws, subject to a requirement that the shareholders own at least 1% of the company's common stock (previously, shareholders were only permitted to submit bylaw amendments subject to director approval). The 1% ownership threshold under the bylaws imposed more onerous restrictions than the shareholding requirements under Rule 14a-8, which requires shareholder proponents to own either 1% of the common stock or $2,000 of the company's securities. ISS recommended against the directors of AvalonBay in 2018 and issued a tentative negative recommendation for 2019. On May 6, 2019, AvalonBay announced that its board had approved a bylaw amendment to allow any shareholder to submit a proposal to amend the company's bylaws by simple majority vote. ISS revised its recommendation after the board removed the ownership threshold requirements and recommended in favor of all AvalonBay directors.

D. LACK OF FORMAL NOMINATING COMMITTEE

The absence of a formal nominating committee continued to be a common basis for negative recommendations against Russell 3000 directors, accounting for 11% of the total number of Russell 3000 directors who received a negative recommendation in 2019. Only two S&P 500 directors were included in this category. Under ISS's policies, the absence of a formal nominating committee will trigger a negative recommendation for all non-independent directors, even if these responsibilities are undertaken by the independent directors as a group, as permitted for listed companies under Nasdaq rules.

For this reason, ISS issued 114 negative recommendations against Russell 3000 directors in 2019, but directors in this category received high levels of shareholder support (90% on average, same as for S&P 500 directors in this category). This data indicates that shareholders generally do not share ISS's concerns in this regard. Last year, no Russell 3000 or S&P 500 directors in this category received less-than-majority support. This year, one Russell 3000 director in this category received less-than-majority support; in that case, in addition to the lack of a formal nominating committee, ISS also cited this non-independent director's proposed service on a key board committee as a basis for its negative recommendation.

E. POOR ATTENDANCE

ISS will recommend a negative vote in the case of a director who attended less than 75% of all board and committee meetings in the relevant year without disclosing an adequate rationale for the director's absences. This was a significant issue for shareholders in prior years but has waned in importance in more recent periods.

This year, the directors in this category only represented 6% of the total number of Russell 3000 directors who received a negative recommendation, and 5% among the S&P 500. Where a director did receive a negative recommendation on this basis, average shareholder support was significantly lower among the S&P 500 (averaging 63%) than among the Russell 3000 (78% excluding S&P 500 directors). Four Russell 3000 directors received less-than-majority support on this basis, and one S&P 500 director received less-than-majority support on this basis. Companies have become more sensitive to this issue and have been including more comprehensive disclosure regarding the reasons for director absence.

Shareholders remain highly sensitive to directors with multiple years of poor attendance absent the disclosure of a sufficient reason for their absences. In its 2019 Voting Guidelines Update, ISS stated that they would begin recommending against members of the nominating/governance committees or the full board in instances of chronic poor attendance of a single director. After three years of poor attendance by a director, ISS will generally recommend against the chair of the nominating/governance committee. After four years, ISS will recommend against the full nominating/governance committee. After five years, ISS will recommend against all directors. For example, this year ISS recommended against all of the directors at P.A.M. Transportation for failing to remove and provide sufficient disclosure about a director whose attendance has repeatedly fallen below the 75% threshold and recommended against all directors of Speedway Motorsports for failing to provide sufficient disclosure regarding a director who failed to meet 75% attendance in the last fiscal year (all directors at both companies received over 50% of votes cast).

F. COMPENSATION ISSUES

This year, the directors who received a negative recommendation for compensation-related reasons represented approximately 16% of the total number of Russell 3000 directors (or approximately 17% excluding S&P 500 directors). Among the S&P 500, compensation-related negative recommendations were more common, with over 25% of all S&P 500 directors who received a negative recommendation falling into this category.

- ***Non-responsiveness to low 2018 say-on-pay vote.*** Sixty-three Russell 3000 directors were at companies that received less than 70% support on the previous year's say-on-pay vote, where ISS determined that the companies failed to respond (or to disclose that they responded) adequately to the underlying concerns through shareholder outreach and changes in compensation programs.[3] Directors in this category represented 6% of the total number of Russell 3000 directors who received a negative recommendation and comprised 38% of directors who received a negative recommendation for compensation-related reasons. Notably, negative recommendations for non-responsiveness to say-on-pay were exclusive to companies *outside* of the S&P 500.

  The average level of shareholder support for Russell 3000 directors in this category (68%) was the third lowest of any category, with six of these 63 directors receiving less-than-majority support. These results reflect the importance of companies with low say-on-pay results focusing their efforts on engaging in shareholder outreach efforts, and disclosing those efforts and any resulting compensation changes in their next proxy statement, to demonstrate to ISS and shareholders that management has taken action with respect to the prior year's vote.

- ***Compensation concerns and no 2019 say-on-pay vote.*** This year 14 directors received negative recommendations for compensation-related reasons at companies that did not have a say-on-pay vote. Similar to non-responsiveness with respect to a low say-on-pay vote, only directors at companies outside of the S&P 500 received negative recommendations based on a failure to hold a say-on-pay vote in the current year. Directors in this category represented only 1% of the total number of Russell 3000 directors who received a negative recommendation.

3 ISS's policy is to vote case-by-case on compensation committee members (or, in exceptional cases, the full board) if the company's prior year say-on-pay vote received less than 70% support, taking into account the company's response (among other factors).

Under ISS's policies, if a company does not have a say-on-pay proposal up for a vote in a particular year, ISS will direct its concerns on compensation issues toward director recommendations (typically against the compensation committee, though "in exceptional cases" ISS will recommend a vote against the full board). The rationales for the negative recommendations in these cases include a disconnect between pay and performance or the inclusion in compensation arrangements of tax gross-up rights or single-trigger severance arrangements. The average level of shareholder support was 80%, and no directors received less-than-majority support on this basis.

- ***Egregious compensation issues.*** This year, the most common compensation-related rationale for an ISS negative recommendation related to "egregious compensation issues" at companies in both the S&P 500 and the broader Russell 3000, accounting for all of the compensation-related negative recommendations among the S&P 500 and the majority of compensation-related negative recommendations among the broader Russell 3000. A total of 91 Russell 3000 directors outside of the S&P 500 and 16 directors at S&P 500 companies received negative recommendations due to such compensation-related concerns, notwithstanding the fact that their companies had a 2019 say-on-pay proposal up for a vote. Directors in this category represented approximately 10% of the total number of Russell 3000 directors who received a negative recommendation (or approximately 9% excluding S&P 500 directors), and represented about a quarter of all S&P 500 directors who received a negative recommendation this year.

  Under ISS's policies, ISS has highlighted several "problematic" compensation practices that will likely result in an adverse recommendation, including repricing or replacing of underwater stock options without shareholder approval, extraordinary perquisites or tax gross-ups, new or materially amended agreements that provide excessive termination or change-in-control payments, and insufficient executive compensation disclosure. The average levels of shareholder support in this category were 84% for both the Russell 3000 and S&P 500, respectively, with only one director (a director at a S&P 500 company) receiving less-than-majority support. Many of the directors in this category were at companies in the tech sector, which was a focus of shareholder proposals as well, as discussed in Part 1 of our annual proxy season review memo. Real estate and healthcare sector directors comprised a meaningful portion of directors in this category. The S&P director who received less-than-majority support this year was the compensation committee chair of Universal Health Services, who received 32% of votes cast after ISS recommended against him for the CEO's compensation package being outsized, lacking performance conditions, and including guaranteed minimum long-term awards.

G. POISON PILL ISSUES

In 2019, there were a meaningful number of negative director recommendations based on poison pill issues, although the 47 directors in this category represented less than 5% of the total number of Russell 3000 directors who received a negative recommendation. While ISS cited this reason in its negative recommendations against a meaningful number of the S&P 500 directors who received a negative recommendation last year, negative recommendations for poison pill issues were exclusive to companies outside of the S&P 500 this year.

ISS implemented new policies on poison pills in its 2018 update, which provided that, for meetings on or after February 1, 2018, ISS would recommend against directors at a company for each year that the company maintains a poison pill with a term of more than 12 months, as opposed to once every three years under the previous policies. Under these policies, ISS will not consider a company's commitment to obtain shareholder approval in the following year a mitigating factor, and long-term poison pills that were put in place before ISS adopted its previous policies are no longer grandfathered. Instead, ISS will recommend against all director nominees (except new nominees, who are considered case-by-case) if the company has in place a poison pill that has not been approved by shareholders or makes any material adverse modifications (*e.g.*, extends, renews or lowers the triggering threshold) to an outstanding poison pill that are not approved by shareholders. ISS will continue to evaluate poison pills with terms of 12 months or less on a case-by-case basis, focusing on the company's reason for adopting the pill and factors such as a commitment to put any renewal to a shareholder vote (instead of the company's overall governance practices).

After ISS issued its 2018 policy update, many companies updated their shelf pill documents with shorter-dated terms, which may account for the decreased prevalence of negative recommendations. These poison pills are compliant with ISS policy and often times will terminate before the company's annual meeting, so ISS will not issue a recommendation on this basis. Russell 3000 directors in this category averaged voter support of 82%, and only three directors received less-than-majority support. These three directors were all at the same company (Old Republic), and ISS noted non-responsiveness to shareholder concerns in addition to poison pill issues at the company in support of its negative recommendations.

H. PLEDGING BY INSIDERS

Under ISS's policies, any amount of hedging, or the significant pledging of stock by directors or executives, will be viewed as a "failure of risk oversight" that can lead to recommendations against some or all directors (commonly audit committee members). ISS's FAQs provide that a "significant level of pledged company stock is determined on a case-by-case basis by measuring the aggregate pledged shares in terms of common shares outstanding or market value or trading volume."[4]

ISS does not provide a bright-line percentage that will be considered "significant" for these purposes as compared to shares outstanding, market value or trading volume. Based on our review of the relevant proxy statements and other filings, these negative recommendations were made at S&P 500 companies where the amount of stock pledged by insiders ranged from 3% to 62% of a class of outstanding stock, broken down as follows:

[4] *See* ISS, U.S. Proxy Voting Procedures & Policies (Excluding Compensation-Related) FAQs, *available at* https://www.issgovernance.com/file/policy/active/americas/US-Procedures-and-Policies-FAQ.pdf, at Question 63. ISS notes, however, that it deems *any* pledging of stock by an insider not to be a responsible use of company equity. Any amount of pledged stock by a director or officer will be a negative factor in the company's corporate governance rating under ISS's QualityScore rating system.

Pledged Shares as a % of Outstanding Class	*Number of S&P 500 Companies at Which Directors Received Negative Recommendations*
3%–10%	5
10%–20%	3
20%–30%	0
30%–40%	1
Over 40% (highest being 62%)	2

In a number of cases, the proxy statements for these companies describe newly adopted anti-pledging policies (with exceptions for pledges already in place) and detail efforts and commitments by insiders and companies to manage down the amount of insider pledging. This is typically in response to similar negative director recommendations from ISS and others in past years. Even for companies that are taking these actions, ISS will continue to recommend against directors if it seems that the amount of pledged shares are significant.

Outside of the S&P 500, there were 37 Russell directors in this category, representing 4% of the total number of Russell 3000 directors who received a negative recommendation. Support for these directors was relatively high, averaging 85% among Russell 3000 directors outside of the S&P 500, and 88% among S&P 500 directors. No director received less-than-majority support, as was the case in 2018.

In most cases, the negative recommendations were made against the incumbent members of the audit committee, given this committee's typical responsibility for risk management. The only exceptions were at companies where the proxy statement expressly states that risk oversight is a function of the full board; in those cases, all incumbent directors received negative recommendations.

Although ISS's policies also call for negative recommendations if there is *any* hedging by insiders (not just a "significant" amount as with pledging), no director has received a negative recommendation on that basis (due, perhaps, to the fact that, unlike pledging, there is no proxy requirement to disclose specific hedging arrangements by insiders, although such information is often available on Forms 4).

I. LACK OF RESPONSIVENESS TO SHAREHOLDERS

Typically, ISS makes a negative recommendation related to a lack of "responsiveness" if the board has failed to act on a successful shareholder proposal from a prior year or failed to address the underlying issue that led to a director receiving a majority "against" vote.[5] In its 2019 Policy Update, ISS indicated it also will vote against directors who fail to act in light of the failure of a management proposal to ratify certain existing charter/bylaw provisions.

[5] For the purposes of this memo, directors who received a negative recommendation for perceived failure to take sufficient steps to address receiving less than 70% support on the prior year's say-on-pay vote, separately discussed in Section F, are not counted in this category.

Responsiveness concerns have not ranked among the top reasons for a negative recommendation in recent years, and this year the number of Russell 3000 directors in this category (28) represented under 3% of the total number of Russell 3000 directors who received a negative recommendation (none were among the S&P 500).

Lack of responsiveness continues to be the most impactful recommendation, with directors in this category averaging the lowest shareholder support (58%) of any category. A quarter of the Russell 3000 directors in this category received less-than-majority support, the only category to exceed 10% this year. Given the significant impact on voting results for directors in this category, issuers should take responsiveness concerns very seriously; the low prevalence of this rationale among Russell 3000 directors and the lack of S&P 500 directors in this category suggest that issuers have been proactive in remedying potential responsiveness concerns.

J. OVERBOARDING

ISS will recommend a negative vote in the case of directors who:

- sit on more than five public company boards; or
- are the CEOs of public companies and sit on more than two public company boards besides their own.

Glass Lewis and other institutional investors use similar, but not identical, overboarding standards. Glass Lewis imposes the same limit of five public company board memberships on directors who are not active executive officers but will generally recommend voting against executive directors who serve on more than one public board other than their own. BlackRock's 2019 policies also provide that it will consider CEOs who serve on more than one public board other than their own overboarded and has a more restrictive threshold for non-executive directors (four total public company board memberships). In clarifying its overboarding analysis for directors who serve in executive roles other than CEO (*e.g.*, executive chair), Glass Lewis stated in its 2019 guidelines that it may consider "the size and location of the other companies where the director serves on the board, the director's board roles at the companies in question, whether the director serves on the board of any large privately held companies, the director's tenure on the boards in question, and the director's attendance record at all companies."[6]

Based on average shareholder support in this category, investors consider overboarding an important issue. In 2019, although only four S&P 500 directors and 26 Russell 3000 directors outside of the S&P 500 fell into this category, the directors in this category averaged relatively low shareholder support of 70%

[6] *See* 2019 Proxy Paper, Guidelines: An Overview of the Glass Lewis Approach to Proxy Advice, *available at* http://www.glasslewis.com/wp-content/uploads/2018/10/2019_GUIDELINES_UnitedStates.pdf.

among S&P 500 directors and 69% among Russell 3000 directors outside of the S&P 500. No director received less-than-majority support this year.

Given the meaningful impact on voting results for directors in this category over the last few years, issuers also have taken overboarding seriously, and the imposition of directorship limits under corporate governance guidelines has become widespread among U.S. public companies. The attention issuers have paid to director overboarding issues has contributed to the decreasing prevalence of ISS negative recommendation on this basis.

K. UNILATERAL ACTION BY THE BOARD

In 2016, ISS adopted a policy to vote against directors who unilaterally adopt bylaw provisions or amendments to the articles of incorporation that materially diminish shareholders' rights. In 2019, the unilateral actions that spurred this recommendation included limiting shareholders' rights to amend the bylaws, adopting a fee-shifting bylaw, amending the company's charter to effect a reverse stock split, adopting a classified board structure and increasing the percent threshold to call a special meeting.

This year, only 12 Russell 3000 directors received a negative recommendation on this basis, and none were among the S&P 500. The average support level for Russell 3000 directors in this category was 71% in 2019, and only one director received less-than-majority support. Although this suggests that, in some cases, shareholders do not view a violation of ISS's standards for these actions as a significant concern, the particular circumstances of the individual issuers may be more relevant. For example, issuers with high insider holdings or supportive investors may be more likely to adopt such changes because they are less concerned about the impact of a negative recommendation.

L. MATERIAL WEAKNESS ISSUES

ISS's policies state that it will vote on a "case-by-case" basis in the event of "poor accounting practices," which include material weaknesses identified in Sarbanes-Oxley Section 404 disclosure. In 2019, there was only one S&P 500 director in this category, and only four Russell 3000 directors (generally audit committee members) outside of the S&P 500. There was a meaningful difference in voting impact between the S&P 500 and the broader Russell 3000, as was the case in 2018. The one S&P 500 director in this category received 70% shareholder support, while the four Russell 300 directors outside of the S&P 500 averaged 80% shareholder support. No director received less-than-majority support.

M. EXCESSIVE NON-AUDIT FEES

ISS will recommend shareholders vote against or withhold from members of the audit committee if the non-audit fees paid to the auditor are excessive, the company receives an adverse opinion on its financial statements from its auditor, or the audit committee entered into an inappropriate indemnification agreement with its auditor that would limit the ability of the company or shareholders to pursue legitimate legal recourse against the audit firm. Under ISS guidelines, non-audit fees are excessive if they exceed the sum of audit fees, audit-related fees and fees associated with the preparation of original and amended tax returns and refund claims and tax payment planning. (ISS includes any other services in the tax category, such as tax advice, planning or consulting, as non-audit.) ISS will vote on a case-by-case basis against members of the audit committee or the full board if poor accounting practices rise to the level of serious concern, such as fraud, misapplication of GAAP or material weaknesses identified in Section 404 disclosures.

Though ISS issued only one negative recommendation in this category to S&P 500 directors and only four to Russell 3000 directors outside of the S&P 500, shareholders appeared to take note, with directors at both S&P 500 and other Russell 3000 companies in this category receiving among the lowest average shareholder support of any category (55% among S&P 500 directors and 60% among Russell 3000 directors outside of the S&P 500). None of these directors, however, received less-than-majority support from shareholders.

N. 2019 ANNUAL POLICY SURVEY

On July 22, ISS launched its annual policy survey to solicit feedback from stakeholders with regards to ISS's benchmark proxy voting policies. Solicitation responses are due no later than 5 p.m. ET on August 9, 2019.

This year, ISS included questions about board gender diversity and what (if any) mitigating factors ISS should consider when recommending against directors for failure to satisfy their board gender diversity requirements. ISS also included questions relating to climate change disclosure and if climate change should be a high-priority component of companies' risk assessments.

ISS is also revisiting the question of overboarding and soliciting feedback about the appropriate policy in regards to a director's other obligations (taking into account that some high-profile independent investors have adopted standards that are in some way more stringent). In addition, ISS is soliciting feedback about independent chair proposals and what factors might suggest the need for an independent chair at a given company. Lastly, ISS is asking stakeholders about the appropriate sunset period for multi-class capital structures and including "Economic Value Added" data in its Quantitative Pay-for-Performance report.

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