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Skadden

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ISS Announces 2016 Updates to US Proxy Voting Guidelines

Proxy advisory firm Institutional Shareholder Services (ISS) recently announced updates to its U.S. proxy voting guidelines for the 2016 proxy season. The updates, which include changes to policies on director elections and compensation matters, are summarized below. These updated policies will become effective on February 1, 2016.

Director Overboarding. As previously proposed, ISS will consider directors who are not CEOs to be "overboarded" if they sit on more than five public company boards, down from the current standard of six boards. However, ISS will provide a transition period and not recommend votes against such directors for 2016. ISS has not changed its policy for a public company CEO, who would be "overboarded" if he or she sits on more than two "outside" boards.

Unilateral Board Actions That "Materially Diminish Shareholders' Rights." ISS noted a recent increase in unilateral amendments to company charters and bylaws that adversely affect shareholder rights. ISS tracked 64 such cases in 2014 and 62 to date in 2015, compared to 10 in 2013. Unless the adverse amendment is subsequently reversed or submitted to a *binding* shareholder vote, ISS will recommend "against" directors who have unilaterally amended the bylaws or charter to classify the board, require a supermajority vote to amend the bylaws or charter, or eliminate shareholders' ability to amend the bylaws. In subsequent years, unless the board reverses the adverse provision or submits it to a binding shareholder vote, ISS will assess director nominees on a case-by-case basis.

ISS also clarified its views by providing a separate approach for newly public companies where the pre-initial public offering (IPO) board took such unilateral actions in connection with the IPO. In such cases, ISS will evaluate whether to provide an adverse recommendation at the annual meeting following an IPO based on the following factors:

- the company's or the board's rationale for adopting the provision;
- the impact on the ability to change the governance structure in the future, such as limitations on shareholder rights or supermajority vote requirements to amend the bylaws or charter;
- the existence of a classified board structure versus the shareholders' ability to hold directors accountable through annual director elections; and
- a public commitment to put the provision to a shareholder vote within three years of the date of the IPO.

Unless the board reverses the adverse provision or submits it to a vote by public shareholders, ISS will also assess director nominees on a case-by-case basis in subsequent years.

Proxy Access. ISS has not changed its existing voting policies with respect to shareholder proxy access proposals, which generally favor proposals with a 3 percent ownership threshold (with no limits on aggregation) and three years of continuous ownership to nominate up to 25 percent of the board. However, a forthcoming "FAQ" document — expected to be released in December 2015 — will describe provisions that ISS considers overly restrictive.

Say-on-Pay Votes for Externally Managed Issuers. ISS added a new policy regarding say-on-pay votes for externally managed issuers (which often include REITs in particular). Executive officers of an externally managed issuer (EMI) typically are compensated by the external manager, which in turn is compensated by the EMI through a management fee. Many EMIs provide few details about executive compensation arrangements in their public disclosure and instead provide information about the nature of the management fee more generally.

In a new policy for which ISS said there was significant investor support, the proxy advisory firm added insufficient disclosure regarding compensation arrangements at EMIs as a problematic pay practice. Accordingly, ISS now generally will recommend against say-on-pay proposals where there is an external management structure in place and insufficient detail in the EMI's disclosure for ISS to perform an adequate pay-for-performance analysis.

It is not entirely clear how ISS will determine whether an EMI provided sufficient disclosure. ISS suggested that it may be sufficient to disclose the aggregate portion of the management fee allocable to executive compensation expenses. ISS indicated, however, that more detailed information is preferable and that, because a "small number" of EMIs already provide more detailed information, doing so appears practicable.

Holding Periods for Executive Equity Compensation. ISS streamlined its policy for assessing shareholder proposals for the adoption of policies requiring senior executives to hold equity incentive compensation plan shares for a specified period. ISS' existing approach hinged on a variety of factors, some of which varied depending on whether the proposed policy generally required named executive officers to retain 75 percent of the shares for at least two years following termination of employment.

Under the new policy, all holding period proposals will be considered under the same standard, which will take the following factors into account on a case-by-case basis:

- the percentage/ratio of net shares required to be retained;
- the time period required to retain the shares;
- whether the company has equity retention, holding period and/or stock ownership requirements in place and the robustness of such requirements (including, in particular, the holding period duration);
- whether the company has any other policies aimed at mitigating risk taking by executives;
- executives' actual stock ownership and the degree to which it meets or exceeds the proponent's suggested holding period/retention ratio or the company's existing requirements; and
- the prevalence of problematic pay practices at the company, current and past, which may demonstrate a short-term versus long-term focus.

ISS noted that its change in approach eliminates the need for separate policies tied to specified retention ratios (*i.e.*, a separate policy for proposals requesting 75 percent net share retention) — since the retention ratio is a factor to be considered for every proposal — and that the new policy accordingly will be more streamlined and easier to understand.

Equity Plan Scorecard (EPSC) Changes. Under the EPSC, ISS engages in a holistic analysis of equity plan approval proposals based on three different factors: (i) plan cost, which measures a company's shareholder value transfer relative to peers; (ii) plan features, including items such as discretionary vesting authority, minimum vesting periods and liberal share recycling; and (iii) grant practices, which focuses on the three-year burn rate relative to peers, vesting requirements under recent CEO grants, estimated duration of the plan and certain other items.

ISS made the following changes to the EPSC for 2016:

ISS adjusted the scoring system for Russell 3000/S&P 500 companies that fall into a new "Special Cases" category, which generally includes companies with less than three years of disclosed equity grant data (typically IPO companies and companies emerging from bankruptcy).

The metric previously named "Automatic Single-Trigger Vesting" has been renamed "CIC Vesting," and ISS adjusted scoring under that metric to provide:

- full points if, for time vested awards, the plan provides for no accelerated vesting or accelerated vesting only if awards are not assumed and, for performance vested awards, the plan provides either for vesting based on actual performance through the change in control and/or on a pro-rata basis through the change in control;
- no points if the plan provides for automatic vesting of time-based awards or payout of performance awards above target; and
- half points if the plan provides for any other change in control vesting terms.

- The holding period required for full points under the Post-Vesting/Exercise Holding Period plan feature is increased from 12 months to 36 months (or until earlier employment termination); half points still will be available for a holding period of at least 12 months.
- ISS adjusted the points allocated to certain factors per ISS' proprietary scoring model. However, the requirement (absent egregious factors) of a score of at least 53 points out of a maximum possible 100 to receive a favorable recommendation is unchanged.

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ISS' summary of the updated voting guidelines is available here. Companies should assess the potential impact of these voting recommendations on matters to be considered by their shareholders during the 2016 proxy season and determine whether any steps should be taken to address that impact.

Companies should also consider whether to make any updates to the **compensation benchmarking peers** included in ISS' database. ISS uses these company-selected peers when it determines the peer group it will use for evaluating a company's compensation programs. ISS will accept updates until 8 p.m. (EST) on **Friday, December 11, 2015**. Information about this process is available here.

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