Cooley

ISS and Glass Lewis Update 2017 Proxy Voting Policies

December 28, 2016

Institutional Shareholder Services (ISS) and Glass Lewis (GL), the two most influential proxy advisory firms, recently released updates to their voting policies for 2017. Both ISS and GL issued policy updates on director overboarding and "newly public" company governance matters. ISS also issued policy updates on certain executive and equity compensation policies, proposals seeking ratification of director compensation, restrictions on binding shareholder proposals and proposals to increase authorized capital for stock distributions. GL also issued a policy update on board self-assessment and refreshment.

Although ISS and GL have a strong following of institutional shareholders, issuers should consider, as a threshold matter, the composition of their particular shareholder bases, the extent to which those shareholders look to ISS or GL in determining whether to support a proxy proposal, and the areas with which their shareholders appear to be most concerned. Some institutional shareholders still follow ISS or GL recommendations without exception, some consider the ISS or GL recommendations as a factor, but not necessarily a determinative factor, in their voting decisions, and others are guided by their own policies, which may or may not overlap with ISS and GL policies. Even if ISS and GL do not have a consequential influence on an issuer's particular shareholders, they are often viewed as standard-setters for best practices in corporate governance, and changes in policies often reflect investors' changing expectations. For this reason, ISS and GL policies are often starting points for board, governance committee and compensation committee discussions on corporate governance.

Director elections

Overboarding

ISS and GL have long-standing policies to determine whether directors are "overboarded," that is, whether they serve on a number of public company boards that ISS or GL views as "excessive." Pointing to increased demands on directors' time, both firms expressed concern that the time commitment associated with service on too many boards could leave directors unable to properly fulfill their duties as directors. Lower overboarding thresholds were announced in 2016, but, for a one-year transition period, both firms included only cautionary language in reports covering directors considered overboarded under the lower standards; in 2017, both firms will begin issuing negative recommendations when overboarding is present.

What is changing?

Under the new policies, ISS will recommend withholding votes from directors who are not CEOs (or, in the case of GL, from directors who are not executive officers) of public companies who serve on more than *five* public company boards. The prior threshold was *six* public company boards.

Starting in 2017, the ISS and GL policies will differ for directors who are CEOs (or, in the case of GL, for directors who are executive officers) of public companies. The ISS policy, which did not change, is to deem public company CEO directors overboarded if they serve on the boards of more than *three* public companies (including their own companies). Under its updated policy, GL will consider public company executive officer – not just CEO – directors overboarded if they serve on the boards of more than *two* public companies (including their own companies). Both ISS and GL will issue negative recommendations for overboarded CEOs/executives only with regard to outside boards.

In its 2017 update, GL expressed an openness to evaluating overboarded directors on a case-by-case basis and, rather than issuing an automatic negative recommendation, considering relevant facts and circumstances before concluding that a director's service on an excessive number of boards limits the director's ability to devote sufficient time to board duties. Relevant factors will include disclosure regarding the size and location of the other companies where the director serves on the board, the director's board duties 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. GL will also consider each company's disclosed rationale for the director's continued board service. GL indicated that the rationale should include information adequate to allow shareholders to evaluate the scope of a director's other commitments as well as his or her contributions to the board, including specialized knowledge of the company's industry, strategy or key markets and the diversity of skills, perspective and background he or she provides. ISS policy does not include a parallel structure for considering case-by-case exceptions.

Observations and commentary

All directors should be updated on the new ISS and GL policies so that they are aware of the potential complications when considering new board service and, if applicable, prepared for negative recommendations from ISS and GL. Additionally, companies should identify directors who currently exceed the new overboarded thresholds and consider whether any action is appropriate. If a director fails to meet the new standards, companies should consider providing, in their proxy statement disclosure, the rationale for the director's continued service and other relevant factors that demonstrate why the board believes that the director is able to devote sufficient time to his or her board duties. While these factors are unlikely to reverse an otherwise negative ISS recommendation, they may help overcome a negative GL recommendation and influence shareholders to vote in favor of the director.

Nominating committees should continue to consider outside board commitments when evaluating each continuing and new director, recognizing that there may be individual circumstances that would justify board commitments in excess of the ISS and GL overboarded thresholds. Some boards have adopted or are considering adopting policies that address outside board commitments, such as policies that require a director to notify the board (or obtain consent) prior to accepting a role on a new board. These policies typically include both public and private company boards and, in some cases, apply only if the proposed new board service would exceed the ISS and GL overboarding thresholds.

Boards should also be mindful that proxy advisory firm policies evolve and could change in the future. In fact, in its most recent annual policy survey conducted in August 2016, ISS sought input from institutional shareholders, issuers and other market constituents on whether non-CEO executive chairs should also be evaluated under the stricter overboarding standard applied to CEOs. Because the majority of investor respondents (64%) were in favor of this concept, it would not be surprising if the ISS policy for non-CEO executive chairs changes in the future.

“Newly public” companies with charter provisions adverse to shareholder rights

Historically, ISS and GL did not analyze actions taken by companies before their initial public offering (IPO) when determining vote recommendations for directors. However, in its 2015 policy updates, ISS signaled a change: where, prior to or in connection with its IPO, a company unilaterally adopted bylaw or charter amendments (i.e., amendments effected without shareholder approval) that materially diminished shareholder rights or that could adversely impact shareholders, that amendment could lead ISS to issue a negative recommendation for directors.

For 2016, ISS expanded its policy, disclosing that it would issue negative recommendations for directors at "newly public" companies that, prior to their IPOs, adopted bylaw or charter provisions that limited board accountability to post-IPO investors and made it difficult for shareholders to amend the company's governing documents or take other corporate actions, including adopting staggered boards and supermajority vote provisions, even when those provisions were approved by the pre-IPO shareholders. ISS said that it would continue to issue negative vote recommendations for directors until the "adverse provisions" were reversed or approved by the public company shareholders and that it would consider recommendations for new board nominees on a case-by-case basis.

The provisions ISS has deemed adverse to shareholders' rights include requiring a supermajority shareholder vote to amend the bylaws or charter, creating a classified board structure and eliminating the ability of shareholders to amend the bylaws, call a special meeting or act by written consent. Under the 2016 ISS policy, when determining whether a particular provision warranted a negative vote recommendation against a director, ISS considered relevant factors, including the level of impairment of shareholders' rights, the rationale for the provision, the ability of shareholders to change the governance structure in the future, whether the board was classified and whether the company made a public commitment to put the provision to a shareholder vote within three years of the IPO.

In the last two years, GL has also applied greater scrutiny to the governance practices of newly public companies. GL generally issues negative recommendations for directors where there are antitakeover provisions that "severely restrict" shareholder rights (e.g., poison pills, classified boards, fee-shifting bylaws); however, GL generally refrains from issuing negative recommendations for directors for other "problematic" governance provisions during the one-year period following an IPO.

What is changing?

For 2017, ISS and GL refined their policies, extending the circumstances under which they will issue ongoing negative recommendations for directors of "newly public" companies that adopted "adverse" bylaw or charter provisions prior to their IPOs. The ISS and GL policies do not define "newly public," but based on informal guidance from ISS, we expect that for 2017 any company that held its first annual meeting after February 1, 2015 will be considered "newly public" by ISS.

ISS. Beginning in 2017, ISS will no longer consider submission of the adverse provision to a public company shareholder vote within three years following the IPO (or a commitment to do so) as an evaluation factor that may prevent a negative recommendation for directors following the IPO; instead, ISS will consider as mitigation a reasonable sunset provision on the adverse provisions. ISS also added adoption of a multi-class capital structure to the types of provisions implemented prior to an IPO that may result in negative recommendations for directors following the IPO (see "Multi-class stock structure at IPO" under "Other changes" below).

GL. Although GL will continue to generally refrain from issuing negative recommendations for directors on the basis of governance standards during the one-year period following an IPO, for 2017 GL identified certain additional provisions that "severely restrict shareholder rights indefinitely" and therefore may trigger immediate negative recommendations for directors at newly public and also spin-off companies: supermajority vote requirements to amend governing documents (about which GL advises shareholders to be particularly cautious), exclusive forum or fee-shifting provisions, prohibitions on shareholders calling special meetings or acting by written consent, prohibitions on the ability of shareholders to remove directors, except for cause, the presence of evergreen provisions in equity compensation plans and plurality vote standards for director elections. Including a sunset provision or sound rationale or submitting the provision to a shareholder vote at the company's first shareholder meeting following the IPO may prevent negative recommendations. In addition, in line with its policy for mature public companies, GL is likely to recommend voting against the nominating and governance committee chair if the company includes an exclusive forum provision in its governing documents in connection with the IPO.

Observations and commentary

Any company that has gone public in the last several years should understand these ISS and GL policies and how they may impact director elections. Although the ISS policy was inconsistently applied last year, we expect that it will be applied more uniformly in 2017 and, therefore, even companies that did not receive negative director vote recommendations in 2016 should expect negative director vote recommendations in 2017, except with respect to new directors who joined after the IPO and have served for less than one year. While ISS will recommend against all directors up for election (excluding new directors), GL may recommend voting only against nominating and governance committee members.

Most governing documents of newly public companies contain many (and often all) of the shareholder protective provisions considered problematic by ISS and GL. Companies adopt these provisions prior to or in connection with their IPOs as "shareholder protection measures" – provisions that give the board the flexibility to protect the shareholders from takeover attempts that it has not negotiated or approved. Unsolicited takeover attempts are often viewed as serious disruptions to the business and management of the company that could result in less favorable terms to the shareholders than would be available in a board-approved transaction. However, ISS, GL and, on varying levels, institutional shareholders generally disfavor these measures because they can also restrict the ability of shareholders to effect other changes.

We do not expect that companies going public will stop adopting shareholder protective provisions simply because they are viewed negatively by ISS or GL. Accordingly, we recommend that companies engaged in the IPO process and those that have recently gone public recognize that these provisions will be disfavored by ISS and GL, and assess the impact of negative director vote recommendations based on their respective shareholder bases and in the context of their voting standards for director elections (which is almost universally a plurality standard for newly public companies). For most newly public companies, the recommendations of ISS and GL do not have a decisive influence on their shareholders and, accordingly, we expect that the ISS and GL policy updates are unlikely to lead most IPO companies to place sunset provisions on their shareholder protective provisions. As a company matures and its shareholder base evolves, the board should carefully monitor the company's shareholder base, engage in dialogue with shareholders regarding governance matters and regularly assess its governance practices, weighing the potential advantages and disadvantages of retaining shareholder protective provisions.

Compensation

Pay for performance

ISS assesses CEO pay relative to corporate performance when determining vote recommendations for say-on-pay proposals. That assessment can, in some cases, also affect recommendations for compensation committee or other board members as well as, in rare cases, equity plan proposals.

The first step in ISS' pay-for-performance evaluation is a quantitative assessment of how well CEO pay has been aligned with the company's total shareholder return (TSR). ISS uses three quantitative screens to assess alignment on an absolute basis and relative to a group of peers selected by ISS. If any or a combination of the three screens indicates a pay-for-performance misalignment, ISS uses its qualitative review of the company's pay programs and practices to understand likely causal or mitigating factors before determining its vote recommendation.

What is changing?

ISS is incorporating additional financial measures to supplement its legacy use of TSR when assessing CEO pay relative to corporate performance. The new metrics and weightings will vary based on each company's Global Industry Classification Standard (GICS) industry group and may include relative evaluations of return on equity, return on assets, return on invested capital, revenue growth, EBITDA growth and cash flow (from operations) growth. The new relative pay and financial performance assessment will not be part of ISS' quantitative pay-for-performance screen in 2017, but it will be considered in ISS' qualitative review and may mitigate or heighten concerns identified in the quantitative screens. **View more about ISS' pay-for-performance policy**, including how ISS will vary the new financial performance metrics and weightings by GICS industry group.

Observations and commentary

We think compensation committees should be mindful of the new ISS performance metrics when setting goals for 2017 incentive compensation programs. Of course, compensation committees should continue to set goals that are aligned with each company's strategic plan and intended to drive the performance that will ultimately result in positive shareholder return. However, the new ISS financial performance metrics can be useful as a consideration in goal-setting because they reflect investor feedback on how executive compensation should be analyzed in the context of company performance. Companies may also want to consider disclosing executive compensation relative to some or all of the new ISS financial performance metrics and company financial performance, using some or all of the new metrics, relative to their self-selected peer groups.

We also recommend each company review its current **GICS industry group classification** to make sure the classification is appropriate. GICS codes are maintained by Standard & Poor's and Morgan Stanley Capital International and consist of sectors, industry groups, industries and sub-industries. **View the GICS sector definitions**. If you believe your company is misclassified, you can appeal by contacting Standard & Poor's at 800 523 4534, and we are available to assist with that process.

Finally, we recommend paying close attention to the relative pay and financial performance assessments included in the research reports that ISS issues for 2017 annual meetings in light of the fact that ISS is considering integrating this type of assessment into its quantitative screen in future years. Although this new assessment will only be part of ISS' qualitative analysis in 2017, the research reports will display the following results: (i) the subject company's CEO pay rank and weighted average performance rank, (ii) the "relative financial performance result," which is the weighted average performance rank minus the CEO pay rank, (iii) a comparison of the relative financial performance results versus companies in the same industry with the same quantitative concern level, (iv) the performance value for each metric, with the metrics sorted by order of importance applicable to the subject company's GICS industry group and (v) a visual representation of the subject company's performance rank for each metric as compared to the ISS-selected peer group.

Equity plan proposals

ISS evaluates most proposals seeking shareholder approval for new or materially amended equity plans using its "scorecard" approach that evaluates plan cost, plan features and equity grant practices. There are also certain plan features that ISS views as "egregious" that may override an otherwise positive vote recommendation.

What is changing?

For 2017, ISS modified one plan feature, added one new plan feature and made minor changes to various factor weightings used in its scorecard model, including the following:

- **Amended minimum vesting factor** – ISS modified this factor so that the one-year minimum vesting period must now apply to all award types in order to receive full credit for this factor. (Historically, full credit was received if the minimum vesting requirement applied to either full value awards, such as RSUs, or appreciation awards, such as stock options.) ISS also clarified that no credit for this factor will be earned if the plan allows for individual arrangements that reduce or eliminate the one-year requirement.
- **New dividend factor** – ISS believes that dividends on unvested awards should be paid only after the underlying awards have

been earned and not during the performance or service vesting period. This new factor considers whether the plan prohibits the payment of dividends until awards vest. A company's general practice of not paying dividends until awards vest will not be enough to get credit for this factor.

Observations and commentary

Many companies that submitted equity plan proposals in prior years received full credit for the minimum vesting plan feature by applying the restriction only to full value awards or appreciation awards. These companies should be aware that in order to receive credit for this feature next time the equity plan is submitted to shareholders, the restriction will need to be expanded to cover both types of awards, and the plan should not permit exceptions in individual award agreements beyond the general minimum vesting exception that ISS allows for awards up to 5% of the aggregate share reserve.

Proposals seeking to amend cash and equity plans for tax or administrative reasons

ISS generally supports incentive plan proposals submitted for purposes of Section 162(m) of the Internal Revenue Code (Section 162(m)) and proposals that address only administrative features under the plan unless the plan or proposal contains excessive problematic provisions or the compensation committee does not consist of only independent directors (as determined under ISS' categorization of directors).

As a reminder, companies submit proposals for purposes of Section 162(m) because, if the material terms of the plan are reapproved by the company's shareholders at least every five years, then performance-based compensation that is granted under that plan and that complies with certain other requirements may be excluded from the $1 million deductibility limit that would otherwise apply to compensation paid to the CEO and three other most highly compensated officers (other than the CFO).

What is changing?

For 2017, ISS clarified that its general approach of supporting Section 162(m) or administrative proposals applies only when other changes are not bundled with the same proposal and only when a company's public company shareholders have previously approved the plan. If the company is submitting the plan to shareholders for the first time after the company's IPO or if the proposal includes other material plan amendments (e.g., extending the term of the plan, requesting additional shares), then ISS will evaluate the proposal on a case-by-case basis and, in many cases, apply the full scorecard analysis described above.

Observations and commentary

Companies that are submitting incentive plan proposals for Section 162(m) purposes should carefully evaluate any other changes they are requesting to the plan, to understand whether those changes would cause the proposal to be subject to heightened review by ISS. While some changes would clearly be material (e.g., a share reserve increase or extension of the plan term), others are less straightforward (e.g., amendments to increase the tax withholding rate for equity awards). We recommend that proposals submitted solely for Section 162(m) purposes carefully describe that limited purpose and why that purpose benefits the company and its shareholders.

While GL and most institutional investors also generally support proposals submitted for Section 162(m) reapproval, we have noticed that they have recently started to oppose plans with evergreen provisions or provisions that allow repricing without shareholder approval even if the plan is being submitted solely for purposes of Section 162(m) and has been previously approved by public company shareholders. Voting against Section 162(m) proposals is contrary to prior patterns of support and is somewhat surprising given that the potential tax benefit is typically in the best interests of shareholders and signals that GL and shareholders find evergreen and repricing provisions so egregious that they're willing to oppose the proposal despite losing the tax benefit.

Proposals seeking ratification of director pay programs

ISS has not historically had a policy for evaluating director compensation. However, in 2016, several companies submitted stand-alone proposals seeking ratification of director compensation programs, leading ISS to develop a framework for analyzing director compensation. We believe the new director compensation proposals were largely driven by recent shareholder litigation asserting breach of fiduciary duty and other claims based on alleged excessive director compensation, and that the 2016 proposals may well have been submitted as part of negotiated settlements. Under Delaware law, any challenge to a board's approval of a director compensation program will be analyzed under the entire fairness standard unless a majority of the board is not interested in the transaction, that is, will not directly benefit from the compensation program. However, if the compensation program is ratified by a fully informed shareholder vote, Delaware law provides that the more deferential business judgment rule would protect the board's approval. Accordingly, obtaining fully informed shareholder ratification of a director compensation program or a limit on direction compensation may deflect litigation or provide a basis to defend against any claims that may be filed.

What is changing?

Under the new policy, ISS will evaluate company proposals based on a number of factors relating to non-employee director compensation, including the magnitude of director pay compared to similar companies, stock ownership guidelines and holding requirements, equity award vesting, the mix of cash and equity compensation, whether there are meaningful limits on director compensation, the availability of retirement benefits or perquisites and the quality of disclosure about director compensation.

Observations and commentary

We recommend companies consider adding director compensation limits when next submitting equity plan proposals to shareholders in light of the benefits of doing so described above, particularly with respect to Delaware law. We also think it is possible that the framework adopted by ISS to analyze director compensation proposals may eventually be expanded to analyze director compensation even in the absence of director compensation or equity plan proposals. As a result, we recommend updating boards on the factors ISS introduced this year and that companies pay particular attention to the quality of their proxy disclosure about director compensation.

Other changes

Equity plans for nonemployee directors – ISS broadened and expanded the factors it will evaluate in analyzing a proposal to approve an equity plan designed only for non-employee directors. The additional factors are relative pay magnitude and meaningful pay limits. The updated policy is intended to better align with the new ISS policy on proposals seeking ratification of director pay programs.

Restrictions on binding shareholder proposals – Over the last few years, shareholders have submitted precatory proposals seeking the right to amend the bylaws at a number of companies that do not provide this right to shareholders. Although ISS has not previously analyzed charters to determine whether they impose restrictions on shareholders' ability to amend the bylaws, these proposals have drawn attention to this issue and led ISS to adopt a new policy to issue ongoing negative recommendations for directors on the governance committee if the company's charter imposes "undue restrictions" on shareholders' ability to amend the bylaws. "Undue restrictions" include an outright prohibition on the submission of binding shareholder proposals, or the imposition of share ownership requirements or time-based holding requirements to submit shareholder proposals in excess of those imposed under Rule 14a-8 adopted under Section 14(a) of the Securities Exchange Act of 1934, as amended (under which shareholders are permitted to submit shareholder proposals, both precatory and binding, to amend bylaws). The recent ISS policy survey highlighted that over two-thirds of Maryland REITs give the power to amend the bylaws exclusively to the board and so while ISS' new policy does not specifically target Maryland REITs, it appears these companies may be particularly implicated.

Multi-class stock structure at IPO – Past ISS policy did not explicitly address director accountability with respect to a company's capital structure in place at the time of its IPO. Starting in 2017, ISS will issue ongoing negative recommendations for directors at companies that complete their IPOs with multi-class capital structures where the classes do not have identical voting rights. Including a reasonable sunset provision on the multi-class structure may prevent negative recommendations. Companies that adopt multi-class (typically dual class) stock structures in connection with their IPOs do so often to concentrate ownership in a family or a small group of shareholders or management that are expected to remain long-term holders of the company's shares after the IPO, to retain control of the company, promote continuity of vision and focus management on growing the company after IPO. Dual-class stock structures have been utilized in recent years at technology companies reliant on founding teams with a particular vision, and typically do not contain short sunset provisions of the type contemplated by ISS and GL. By virtue of these structures' concentrating voting control in a few shareholders, we expect the ISS and GL policy change to have little to no practical impact for these companies.

Stock distributions – splits and dividends – ISS clarified that, with respect to management proposals to increase authorized common stock for a forward stock split or share dividend, it will support the proposal if the effective increase in authorized shares is equal to or less than the number of shares ISS would support under its common stock authorization policy.

Board succession and refreshment – GL clarified its approach to board succession planning and refreshment. The updated policy emphasizes that, instead of automatic board retirement or tenure limitations, GL strongly supports a routine and robust board evaluation process focused on the assessment and alignment of director skills with company strategy.

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