Pearl Meyer

CLIENT ALERT

ISS and Glass Lewis Update 2016 Voting Policies

Compensation Peer Group Verification Window Now Open

It's that time of year when proxy advisory services provide revised guidance for 2016 voting recommendations. Institutional Shareholder Services Inc. (ISS) and Glass, Lewis & Co. (Glass Lewis) have now both released updates to their respective proxy voting guidelines[1]. This Client Alert summarizes significant updates to each proxy advisory firm's policies for the 2016 proxy season, with ISS updates applicable for annual meetings on or after February 1, 2016, and Glass Lewis revised policies applying to meetings that are held on or after January 1, 2016.

In addition, the window has opened for companies to notify ISS and Glass Lewis of updates to self-selected compensation benchmarking peers.

For ISS, companies with annual meetings between February 1, 2016 and September 15, 2016 may notify ISS of updates to their self-selected 2015 compensation benchmarking peers between November 24, 2015 and December 11, 2015[2]. Only companies that have made changes to their peer group between the 2015 and 2016 proxy statements need to make a submission. If no changes are submitted, the disclosed peer group from the company's 2015 proxy filing will automatically be factored into the ISS peer selection process. If a company anticipates making changes to its peer group for 2016 compensation decisions, ISS has indicated that submitting an updated peer group within the current window would be helpful if the anticipated 2016 changes are due to business events that have made companies in the 2015 peer group no longer relevant (e.g., significant business changes, mergers, spinoffs, or bankruptcies). ISS also announced that, for the first time, companies in the Russell MicroCap Index (R3KE) will be included in the ISS peer submission process.

For Glass Lewis, the peer update window is open through the Equilar site and will run through December 31, 2015 for meetings between January 15, 2016 and June 15, 2016.[3]

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[1]See: ISS 2016 updates (dated Nov. 20, 2015) at http://www.issgovernance.com/file/policy/executive-summary-of-key-2016-updates-and-policy.pdf and Glass Lewis 2016 updates (dated Nov. 13, 2015) at http://www.glasslewis.com/assets/uploads/2015/11/GUIDELINES_United_States_20161.pdf

[2]See: http://www.issgovernance.com/file/faq/uspeergroupfaq_20151118final.pdf

[3]See: https://insight.equilar.com/app/peer_update/peer_update_faq.jsp?mkt_tok=3RkMMJWWfF9wsRomrfCcI63Em2iQPJWpsrB0B/DC18kX3RUpJ7yXfkz6htBZF5s8TM3DUFVAXrlM6kEATbc%3D

2016 Policy Changes at a Glance

ISS - Compensation

- **Enhanced disclosure for externally-managed issuers (EMIs).** Recommendation against say-on-pay (SOP) when the EMI fails to provide sufficient compensation disclosure for named executive officers (NEOs) who are paid by an external (non-public) company.
- **Updates to the Equity Plan Scorecard (EPSC).** Clarification provided on certain provisions including impact of change-in-control (CIC) vesting and post-vesting/exercise holding periods.
- **Shareholder proposals on equity holding periods.** Streamlined policy issued.

ISS - Other

- **Overboarding.** Recommendations issued against a Director who (i) is CEO of a public company and sits on more than two other public company Boards (no change) or (ii) serves on more than five public company Boards (down from six in current policy).
- **Unilateral Board actions following IPO.** Some relief provided to IPO companies.
- **Proxy access.** No immediate change to approach, but additional FAQs forthcoming.

Glass Lewis - Compensation

- **Enhanced disclosure for incentive awards.** Annual and long-term awards require enhanced disclosure.
- **Enhanced disclosure for transitional awards.** More detailed justification needed for sign-on grants.
- **Equity plan proposals.** Qualitative assessment portion of review updated and clarified.
- **Say on golden parachute (SOGP) considerations.** Excise tax gross-up now considered.

Glass Lewis - Other

- **Overboarding.** Recommendations issued against a Director who (i) is an executive officer and sits on more than two public company Boards (down from three in current policy) or (ii) serves on more than five public company Boards (down from six in current policy).
- **Exclusive forum provision for IPOs.** Revised policy for voting on Nominating Chair where exclusive forum provision adopted by companies with recent IPO.
- **Nominating Committee Chair performance.** Recommendations against the Chair where there is failure to ensure Board has relevant experience.
- **Codification of responsibility for environmental and social risk oversight.** Director responsibilities clarified.
- **Dueling management and shareholder proposals on the same topic.** In determining how to vote, five specific facts and circumstances will be considered by Glass Lewis.

ISS 2016 Key Policy Changes

Enhanced disclosure for externally-managed issuers (EMIs)

Earlier in the season, ISS expressed concern over the lack of transparency in compensation disclosure of EMIs, which typically pay fees to an external management firm in exchange for management services. In these cases, executives are compensated by the external manager which is not subject to public company compensation disclosure obligations. Rather, the EMI is only required to report aggregate management fees paid by the EMI to the manager, which – according to ISS – provides insufficient information to investors to make informed SOP votes. In response, ISS has adopted a new voting policy in which it will generally recommend against SOP when the EMI has provided insufficient compensation disclosure to allow investors to make a reasonable assessment of pay programs and practices for the EMI's NEOs.

> ***Pearl Meyer Observation:*** This new policy will likely have the most profound impact on Real Estate Investment Trusts (REITs) which typically have an external management function. It is troubling that ISS is essentially requiring disclosure of a private entity (the external manager) in addition to that of the public entity (e.g., the REIT), the former of which is not subject to U.S Securities and Exchange Commission (SEC) compensation reporting. It will also require disclosure of decisions that are not even within the purview of the REIT's Compensation Committee. Nonetheless, companies so structured will now need to review their prior proxy compensation disclosure and determine what, if any, additional disclosure should be provided about compensation paid by the external manager to NEOs given the new policy.

Updates to the Equity Plan Scorecard (EPSC)

New "Special Cases" category

In 2015, ISS adopted a new way of evaluating equity plans up for shareholder approval using the EPSC[4] which replaced the former pass-or-fail test based only on plan cost. The EPSC requires an equity plan to accumulate 53 out of 100 possible points to garner a favorable ISS recommendation. The EPSC considers multiple factors falling into three categories with specific weightings based on size and status, which generally include (i) Plan Cost (focused on "shareholder value transfer" as computed by ISS), (ii) Plan Features (focused on treatment of equity upon CIC, vesting provisions, share recycling), and (iii) Grant Practices (focused on burn rates, CEO equity provisions, plan duration, clawbacks, and holding periods).

Scoring of equity plans proposed for meetings on or after February 1, 2016 will be as follows (with changes for 2016 indicated in red):

[4] See our detailed EPSC Client Alert at http://www.pearlmeyer.com/Pearl/media/PearlMeyer/ClientAlerts/PMP-CA-ISSProposed2015Policy-10-14.pdf

2016 EPSC Weightings

Pillar	Model	Maximum Pillar Score	Comments
Plan Cost	S&P 500, Russell 3000, Non-Russell 3000	45	All models include the same Plan Cost factors
	Special Cases-Russell 3000/S&P 500*	50	
	Special Cases-non-Russell (formerly IPO/Bankruptcy)	60	
Plan Features	S&P 500, Russell 3000	20	All models include the same Plan Features factors
	Non-Russell 3000	30	
	Special Cases-Russell 3000/S&P 500*	35	
	Special Cases-non-Russell* (formerly IPO/Bankruptcy)	40	
Grant Practices	S&P 500, Russell 3000	35	The Non-Russell 3000 model includes only Burn Rate and Duration factors. The Special Cases model for Russell 3000/S&P 500 firms includes all Grant Practices factors except Burn Rate and Duration. The Special Cases-non-Russell model does not include any Grant Practices factors.
	Non-Russell 3000	25	
	Special Cases-Russell 3000/S&P 500*	15	
	Special Cases-non-Russell* (formerly IPO/Bankruptcy)	0	

*Generally covers recent IPO or bankruptcy-emergent companies that do not disclose three years of grant data

Automatic Single-Trigger Vesting

The “Automatic Single-Trigger Vesting” under the Plan Features Category is renamed to “CIC Vesting,” with more specificity provided as to its impact:

- **Full points** if plan provides:
  - For time-based awards: no acceleration or accelerated vesting only if awards are not assumed/converted; and
  - For performance-based awards: forfeited, terminated, paid pro-rata, and/or based on actual performance.
- **No points** if plan provides for automatic acceleration of time-based equity or above-target vesting of performance awards.
- **Half points** if plan provides for any other vesting terms related to a CIC.

Extension of Post-Hold Periods

For the “Post-Vesting/Exercise Holding Period” in the Plan Features category, the period required for full points has been increased to 36 months (up from 12 months in 2015) or until employment termination. Companies that maintain a 12-month holding period will receive half points.

> ***Pearl Meyer Observation:*** The EPSC approach did not have a noticeable impact on the number of “Against” recommendations issued by ISS (roughly 20% in both 2014 and 2015) or the very few plans that failed to garner shareholder approval in either year. It is nonetheless advisable that companies planning to include an equity plan on the ballot for the next annual meeting review the data points considered by ISS in its “Equity Plan Data Verification Portal” to ensure the correct information is being input into the scorecard analysis.

Shareholder proposals on equity holding periods

ISS has streamlined its policy for assessing shareholder proposals that ask companies to adopt policies requiring executive officers to retain all or a significant portion of net shares acquired through compensation plans (eliminating bifurcated methodologies for proposals requesting more than/less than 75%+ retention rates and those impacting NEOs vs. senior executive officers). Under the revised policy, ISS will recommend case-by-case on shareholder proposals seeking the adoption of share retention policies for executive officers, taking into account the following factors:

- The percentage/ratio of net shares to be retained
- Time period required
- The robustness of any equity retention, holding periods, or stock ownership requirements already maintained by the company
- Risk-mitigating compensation policies
- Executives’ actual stock ownership and the degree it meets or exceeds the thresholds in the proposal
- Problematic pay practices, current and past, which may demonstrate a short-term versus long-term focus.

Director overboarding

ISS lowered the maximum number of directorships a Director nominee other than the company’s sitting CEO may have before being considered “overboarded”. Specifically, it will recommend voting against a Director who (i) is CEO of a public company and sits on more than two other public company Boards (no change from current policy) or (ii) serves on more than five public company Boards (down from six in the current policy). The new policy is subject to a one-year transition period – for 2016, ISS will only include cautionary language about the overboarded Director in the proxy voting recommendation report. Negative recommendations will continue to apply only to directorships other than the CEO’s own company. The new policy will go into effect for meetings as of February 1, 2017.

Unilateral Board actions following IPO

ISS’ current policy recommends that shareholders vote against Directors, Committees, or the entire Board if the Board amends the company’s bylaws or charter without shareholder approval in a way that diminishes shareholders’ rights (unilateral Board actions). This policy has now been bifurcated in how it applies to established versus newly public companies and the consequences in the years after adoption.

For existing public companies, ISS is likely to recommend against unilateral amendments to (i) classify the Board; (ii) adopt supermajority vote requirements; or (iii) eliminate the shareholders' ability to amend bylaws. In subsequent years, ISS will consider on a case-by-case basis whether to continue recommending against Boards unless the amendment is reversed or submitted to a shareholder vote. For IPO companies, recommendations will be based on consideration of multiple factors, including: (i) the level of impairment of shareholders' rights; (ii) the rationale for adopting the provision; (iii) the provision's impact on the ability to change the governance structure in the future (e.g., limitations on shareholder right to amend the bylaws or charter, or supermajority vote requirements to amend the bylaws or charter); (iv) the ability of shareholders to hold Directors accountable through annual Director elections, or whether the company has a classified Board structure; and (v) a public commitment to put the provision to a shareholder vote within three years of the IPO. In subsequent years, unless the unilateral action is reversed or submitted to a vote, ISS will vote on a case-by-case basis on Director nominations.

Proxy access

ISS stated that its basic approach to management and proxy access proposals will remain unchanged for 2016, but will release updated FAQs in December to provide more information on which proxy access provisions ISS considers overly restrictive. The policy update also clarifies the factors ISS will consider in evaluating an actual proxy access nomination and the Director candidate, which is similar to the analytical framework it uses for proxy contests.

Glass Lewis 2016 Key Policy Changes

Enhanced disclosure for incentive awards

For annual incentives (bonus), Glass Lewis will look for disclosure and explanation of any increases in potential target and maximum amounts (previous policy only required explanation of increases to maximum amounts). In addition, for long-term incentives, actual performance and vesting levels for previous grants earned during the fiscal year should be disclosed, in addition to grants made during the year.

Enhanced disclosure for transitional awards

Sign-on and "make whole" awards for new hires will require a higher level of justification. They should be clearly disclosed and accompanied by a meaningful explanation of the payments and the process by which the amounts were reached, including the details of and basis for such payments. Glass Lewis acknowledges that while in limited circumstances such deviations may not be inappropriate, shareholders should be provided with a meaningful explanation of any additional benefits agreed upon outside of the regular arrangements. For severance or sign-on arrangements, it will consider the executive's regular target compensation levels or the sums paid to other executives (including the recipient's predecessor, where applicable) in evaluating the appropriateness of such an arrangement.

Equity plan proposals

Glass Lewis analyzes equity plan proposals on both a quantitative and qualitative basis. In the past, Glass Lewis has focused on factors including plan administration, the method and terms of exercise, repricing history, express or implied rights to reprice, and the presence of evergreen provisions under the qualitative analysis. For 2016, additional guidance has been provided which will now include the choice and use of, and difficulty in meeting, the awards' performance metrics and targets, if any. In addition, any significant changes to the terms of a plan should be clearly indicated. Finally, Glass Lewis may consider a company's size and operating environment, as well as its overall executive compensation practices in making its recommendation.

Say on golden parachute (SOGP)

Glass Lewis analyzes golden parachute arrangements on a case-by-case basis, taking into account, among other items: the nature of the CIC transaction, the ultimate value of the payments particularly compared to the value of the transaction, the tenure and position of the executives in question before and after the transaction, any new or amended employment agreements entered into in connection with the transaction, and the type of triggers involved (i.e., single vs. double). For 2016, any excise tax gross-up obligations will also be considered.

Overboarding

Beginning in 2017, Glass Lewis will recommend voting against a Director who (i) is an executive officer of a public company and sits on more than two public company Boards including their own (down from three in current policy) or (ii) serves on more than five public company Boards including their own (down from six in current policy). Like ISS, Glass Lewis will note a concern about these Directors in 2016 under a transition period before putting the full policy into effect.

Exclusive forum provisions (for IPO companies only)

Glass Lewis changed its approach to companies that include exclusive forum provisions in their governing documents in the case of IPO companies. Instead of recommending against the Chair of the Nominating and Governance Committee as it would for an established company, Glass Lewis will evaluate this provision when adopted by an IPO company alongside other bylaw terms, such as supermajority vote requirements and a classified Board.

Nominating Committee Chair performance

Glass Lewis has clarified its guidelines to indicate that it may recommend voting against the Chair where a company's poor performance may have been caused by failure to ensure the Board has relevant experience (caused by either failure to conduct periodic Director assessments or lack of Board refreshment).

Codification of responsibility for environmental and social risk oversight

Glass Lewis will recommend against Directors responsible for risk oversight in cases where the Board or management failed to sufficiently identify and manage a material environmental or social risk that did or could negatively impact shareholder value. Examples of environmental risks include oil or gas spills, contamination, hazardous leakages, explosions, or reduced water and air quality.

Examples of social risks include non-inclusive employment policies or inadequate human rights policies.

Dueling management and shareholder proposals on the same topic

Beginning in 2016, Glass Lewis will consider the following factors when reviewing conflicting management and shareholder proposals: (i) nature of the underlying issue; (ii) benefit to shareholders by implementing the proposal; (iii) materiality of the differences between the terms of the shareholder and management proposals; (iv) appropriateness of the provisions considering the company's shareholder base, corporate structure, and other relevant circumstances; and (v) the company's overall governance profile, specifically including its responsiveness to shareholders evidenced by the company's response to previous shareholder proposals and its adoption of progressive shareholder rights provisions.

Conclusion and Action Items

While compensation-related proxy advisor updates were modest for 2016, companies should remain vigilant in keeping abreast of "best practices", particularly for garnering low hanging fruit on "scored" items. Keeping proxy advisors updated on any changes or clarifications is important, and there are multiple opportunities to keep advisors on track for understanding pay programs and avoiding errors, including:

- Updating company peer groups with both ISS and Glass Lewis during applicable window periods;
- Registering for ISS voting recommendation review process (for S&P 500 companies) which will provide a draft report on voting recommendations with a 48-hour window to respond to errors;
- Verifying the company's ISS QuickScore Report (which includes a compensation category) anytime (except between proxy filing and shareholder meeting date); and
- Registering with ISS' Equity Plan Data Verification Portal if an equity plan is being put on the ballot.

Pearl Meyer is available to assist clients in these interactions with proxy advisors, as well as reviewing existing pay programs and any modifications thereto during the year as it relates to other institutional investor guidelines.

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About Pearl Meyer

Pearl Meyer is the leading advisor to Boards and senior management on the alignment of executive compensation with business and leadership strategy, making pay programs a powerful catalyst for value creation and competitive advantage. Pearl Meyer's global clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private companies to the Fortune 500 and FTSE 350. The firm has offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, London, Los Angeles, and San Francisco.

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