ISS Issues 2017 Policy Updates

Institutional Shareholder Services ("ISS") has updated its U.S. corporate governance benchmark policy guidelines for 2017. Other than the addition of several relative financial metrics to its methodology for evaluating the link between pay and performance (see our recent Thoughtful Pay Alert, "ISS Updates 'Pay for Performance' Methodology" (Nov. 21, 2016), this year's updates contain one notable compensation-related item, which applies to the framework ISS uses to evaluate the compensation the non-employee members of a company's Board of Directors. Generally, this policy update provides for the evaluation of a broader range of factors and more careful consideration of director compensation with respect to both advisory proposals seeking shareholder approval of non-employee director compensation programs and, in some cases, proposals to approve "standalone" equity compensation plans for non-employee directors. These changes will be reflected in the corporate governance and executive compensation policies that ISS will use to determine its voting recommendations for its proxy advisory clients during the upcoming 2017 proxy season.

The ISS' Benchmark U.S. Corporate Governance Policies updates are available on the ISS web site.

Significance of Policies

As a long-time advisor to the institutional investor community, ISS is the bellwether for the key shareholder issues to be addressed each proxy season. ISS regularly publishes annual updates to its standards on corporate governance and executive compensation policies and practices. The standards for U.S.-based companies, which are contained in a policy statement published in advance of each year's proxy season, are used by ISS to formulate the voting recommendations that it provides to its clients for the election of directors, the "Say-on-Pay" vote, the approval of employee stock plans, and other proposals submitted for shareholder action at annual shareholders' meetings, as well as to analyze companies' corporate governance and executive compensation policies and practices.

While most technology and life sciences companies focus on the policy updates that affect their executive compensation programs, these updates actually encompass a broad range of corporate governance, social, and environmental matters as well. For example, this year's policy updates also address ISS'' analysis of several corporate governance practices (some of which are noted below).

This article summarizes the key executive compensation and corporate governance-related policy updates for 2017. These policies will be effective for annual meetings of shareholders taking place on or after February 1, 2017.

Non-Employee Director Compensation

ISS is expanding its framework for evaluating the compensation of the non-employee members of companies' Boards of Directors. This expansion will take two forms.

Ratification of Director Compensation Programs

First, in response to the spate of recent litigation over director compensation ISS has added a new policy pursuant to which it will assess company proposals seeking approval or ratification of director compensation programs based on the following factors:

- The relative magnitude of director compensation compared to companies of a similar profile;
- The presence of "problematic" pay practices relating to director compensation;
- Director stock ownership guidelines and holding requirements;
- Equity award vesting schedules;
- The mix of cash and equity-based compensation;
- Meaningful limits on director compensation;
- The availability of retirement benefits or perquisites; and
- The quality of the disclosure about director compensation.

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Approval of "Stand-Alone" Director Compensation Plans

ISS has revised the factors that it considers when formulating its voting recommendation for equity compensation plans that apply only to the non-employee members of the Board of Directors. Generally, ISS will determine its vote recommendation on a case-by-case basis after considering the following factors:

- The total estimated cost of the company's equity plans relative to its industry/market capitalization peers (measured using the company's estimated Shareholder Value Transfer based on new shares requested plus shares remaining for future grants, plus outstanding unvested/unexercised awards;
- The company's three-year burn rate relative to its industry/market capitalization peers; and
- The presence of any "egregious" plan features.

Where the plan exceeds the plan cost or burn rate benchmarks when combined with the company's other employee stock plans, ISS will determine its vote recommendation on a case-by-case basis taking into consideration the factors described above for evaluating a proposal to ratify a director compensation program.

While this latter revision provides helpful clarity on how ISS will conduct its evaluation, to date "stand-alone" director equity compensation plan proposals have been very rare. Consequently, unless practice evolves dramatically in the near future, as a practical matter, this change will likely not affect many technology and life sciences companies.

Additional information about the precise nature and scope of these factors may be included in ISS' "Frequently Asked Questions and Answers" ("FAQ") document to be published in December 2016.

Equity Plan Scorecard Updates

In advance of the 2015 proxy season, ISS introduced a new methodology, the Equity Plan Scorecard (or "EPSC"), for evaluating employee stock plan proposals. Using a "holistic" approach, the EPSC considers a range of factors that fall under three general categories – Plan Cost, Plan Features, and Grant Practices – to arrive at a numerical score that determines whether ISS recommends "for" or "against" an employee stock plan proposal.

Dividends on Unvested Equity Awards

ISS continues to make the EPSC more prescriptive, this year revising the factors and weightings under the methodology for the 2017 proxy season. In addition to minor changes to various factor weightings, the updated policy will include one additional factor: an evaluation of the payment of dividends on unvested awards. Under this new factor, full points will be earned if the employee stock plan expressly prohibits for all award types the payment of dividends before the vesting of the underlying award. (Note, however, that the accrual of dividends for payment upon vesting is acceptable.). No points will be earned if this prohibition is absent or incomplete (that is, not applicable to all award types). A company's general practice (which is not expressly enumerated in the plan document) of not paying dividends until vesting will not suffice.

Minimum Vesting Requirements

Modifications have also been made to the minimum vesting factor. First, an employee stock plan must specify a minimum vesting period of one year for all award types under the plan in order to receive full points for this factor. Second, no points will be earned if the plan allows for individual award agreements that reduce or eliminate the one-year vesting requirement.

Additional information about the revisions to the EPSC methodology will be included in ISS' Equity Compensation Plans FAQ document to be updated and published in December 2016.

Amendments to Cash and Equity Plans

ISS has restructured its policy with respect to the factors it considers when formulating a voting recommendation for cash and equity compensation plans to more clearly differentiate the evaluation framework that it will apply to the various types of proposed amendments. The revision makes no substantive changes to existing ISS policies, but merely seeks to make it easier to understand the criteria that will be applied for different types of amendments.

Routine Amendments

Generally, ISS will recommend a "for" vote for proposals to amend executive cash, stock, or cash and stock incentive plans if the proposal:

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- Addresses administrative features only; or
- Seeks approval for Section 162(m) purposes only, and the plan administrator is a committee consisting entirely of independent outsiders (per ISS' categorization of directors). If a company is presenting the plan to shareholders for the first time after its IPO, or if the proposal is bundled with other material plan amendments, then the recommendation will be determined on a case-by-case basis.

Further, ISS will recommend a vote "against" proposals to amend executive cash, stock, or cash and stock incentive plans if the proposal:

- Seeks approval for Section 162(m) purposes only, and the plan administrator does not consist entirely of independent outsiders (per ISS' categorization of directors).

Amendments to Cash Incentive Plans

ISS will determine its vote recommendation on a case-by-case basis on all other proposals to amend cash incentive plans. This includes plans presented to shareholders for the first time after the company's IPO and/or proposals that bundle a material amendment or amendments other than those for Section 162(m) purposes.

Amendments to Equity Incentive Plans

ISS will determine its vote recommendation on a case-by-case basis on all other proposals to amend equity incentive plans after considering the following:

- If the proposal requests additional shares and/or the amendments may potentially increase the transfer of shareholder value to employees, the recommendation will be based on the EPSC evaluation as well as an analysis of the overall impact of the amendments.
- If the plan is being presented to shareholders for the first time after a company's IPO, whether or not additional shares are being requested, the recommendation will be based on the EPSC evaluation as well as an analysis of the overall impact of the amendments.
- If there is no request for additional shares and the amendments are not deemed to potentially increase the transfer of shareholder value to employees, then the recommendation will be based entirely on an analysis of the overall impact of the amendments. The EPSC evaluation will be shown for informational purposes only.

Corporate Governance Policy Updates

In addition to the foregoing compensation-related policies, ISS has also revised a number of corporate governance policies for U.S. companies, including a policy applying to companies with dual class stock structures:

IPO Companies with Unilateral By-Law or Charter Provisions or a Dual Class Stock Structures

ISS has revised its policy on the assessment of newly-public companies with perceived "adverse" corporate governance features, including multi-class share structures with unequal voting rights. Specifically, beginning in 2017, ISS will generally recommend "withhold" or "against" votes on directors individually, committee members, or the entire board (except new nominees, who will be considered on a case-by-case basis) if, prior to or in connection with its IPO, the company or its Board of Directors adopted by-law or charter provisions materially adverse to shareholder rights, or implemented a multi-class capital structure in which the classes have unequal voting rights after considering the following factors:

- The level of impairment of shareholders' rights;
- The rationale disclosed for the provision;
- The ability to change the governance structure (for example, limitations on shareholders' right to amend the by-laws or charter, or supermajority vote requirements to amend the by-laws or charter);
- The ability of shareholders to hold directors accountable through annual director elections, or whether the company has a classified board structure;
- Any reasonable "sunset" provision; and
- Other relevant factors.

Further, unless the adverse provision and/or problematic capital structure is reversed or removed, ISS will decide whether to recommend "withhold" or "against" votes on director nominees on a case-by-case basis in subsequent years.

What's Next?

As indicated above, ISS will issue a more detailed policy summary in December 2016 that contains additional guid-

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ance related to its benchmark policy guidelines for U.S. companies, as well as the FAQ documents described above. In addition, ISS will be publishing updated "burn rates" in December for each GICS industry/index group.

Need Assistance?

Compensia has significant experience in helping companies understand and address ISS' corporate governance and executive compensation policies. If you have any questions on the topics covered in this Thoughtful Pay Alert or would like assistance is assessing how the policies are likely to affect your executive compensation program, please feel free to contact us. ■

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