ISS Issues 2016 Policy Updates

Institutional Shareholder Services ("ISS") has updated its U.S. corporate governance benchmark policy guidelines for 2016. This year's updates contain one significant compensation-related item, which applies only to companies with external managers (that is, companies which are overseen by a third-party management firm) and some refinements to ISS' equity plan proposal voting guidelines. 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 2016 proxy season.

The ISS' Benchmark U.S. Corporate Governance Policies updates are available on the ISS Governance 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 good 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 corporate governance structure and 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), as well as shareholder proposals on climate change disclosure.

This article summarizes the key executive compensation policy updates for 2016.

Revisions to Equity Plan Scorecard

During the 2015 proxy season, ISS introduced a new methodology, the Equity Plan Scorecard (or "EPSC") for evaluating employee stock plan proposals. Using a more "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.

While ISS made no major changes to the EPSC for the 2016 proxy season, it has refined the EPSC methodology in the following ways:

- It added a limited "Grant Practices" category for newly-public Russell 3000 companies (previously, newly-public companies were not evaluated for their equity award grant practices);
- It revised the scoring/review standard for the treatment of equity awards in the event of a change in control. ISS will still provide full credit where an employee stock plan provides for full acceleration of vesting where outstanding equity awards are not assumed or substituted for by an acquirer. In addition, ISS will provide full credit where the employee stock plan provides that performance-based awards are either forfeited or terminate or vest based on actual performance as of the change in control and/or on a pro-rata basis for time-lapsed awards in ongoing performance periods.

  ISS, however, will now only provide half credit where a plan provides for performance-based awards to pay out at the target level (even on pro-rata basis) in connection with a change in control or an involuntary termination of employment following a change in control. ISS will continue to provide no credit in this category where the employee stock plan provides for "single trigger" award acceleration and where performance-based awards pay out at "above target" levels (if not tied to actual measured performance).

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- To receive full credit where a company has a stock holding period requirement for shares acquired pursuant to the exercise or vesting of equity awards, the shares must be held for 36 (rather than 12) months (or until the end of employment). A 12-month holding period requirement will now receive only half credit.

In addition to the policy updates, ISS has updated its lengthy "Frequently Asked Questions" document on the EPSC, which is available here.

Externally-Managed Issuer Compensation Practices

Some companies (primarily real estate investment trusts) hire a third party firm to provide the individuals who perform the executive officer functions for them. Concerned that the disclosure of the compensation arrangements for these individuals are often opaque and, therefore, unhelpful, ISS plans to treat the disclosure as a "problematic pay practice" if it believes an "externally managed" company has failed to provide sufficient information for shareholders to evaluate these arrangements.

Corporate Governance Policy Updates

In addition to the foregoing compensation-related policies, ISS has also revised a number of corporate governance policies, including the following:

- **Director "Overboarding"** – ISS has reduced the number of board seats that an individual may hold before triggering a negative recommendation for his or her re-election to the board of directors from six to five. For 2016, ISS will simply note in its report if a director serves on more than five public company boards. It will begin recommending that shareholders vote against directors who sit on six or more public company boards starting with annual meetings held on or after February 1, 2017. In the case of a public company CEO officer who also serves as a director, ISS will continue to recommend against the director if he or she sits on the board of directors of more than two public companies (in addition to his or her own company).
- **Unilateral Charter or By-Law Changes** – Currently, ISS will issue a negative recommendation for the re-election of individual directors (or, in some instances, an entire board or board committee) where a board has amended the company's charter document or by-laws without shareholder approval to "materially diminish shareholders' rights." Such amendments may include adopting a classified board, adopting "supermajority" vote requirements, or eliminating shareholder's ability to amend the company's by-laws. This policy has been updated to differentiate between unilateral board amendments made prior to or in connection with a company's IPO and those made after the IPO.
- **Proxy Access** – While ISS has not made any changes to its policy guidelines for evaluating shareholder proposals on proxy access, it has indicated that it will issue a "Frequently Asked Questions" document in December 2016 to provide more information on which proxy access provisions it considers too restrictive.

What's Next?

As indicated above, ISS will issue a more detailed policy summary in December 2016 that contains additional guidance related to its benchmark policy guidelines for U.S. companies. 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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About Compensia

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