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Meridian Client Update

ISS Issues Final Policy Updates for 2016 and Provides Guidance on Equity Plan Proposals

On November 20, 2015, Institutional Shareholder Services (ISS) issued final updates to its proxy voting policies that largely reflect the updates as initially proposed by ISS (see Meridian Client Update dated November 9, 2015). In addition, ISS has issued additional guidance on its voting policy on equity plan proposals.

Final Policy Updates for 2016

The policy updates revise ISS proxy voting policies for U.S. listed companies in the following three areas relating to executive compensation and corporate governance:

- Director Overboarding (i.e., a director sitting on an "excessive" number of boards);
- Unilateral Board Actions; and
- Shareholder Proposals Requiring Holding Equity Post-Employment or for a Significant Period of Time.

These policy updates take effect for shareholder meetings occurring on or after February 1, 2016.

Director Overboarding

ISS is revising its existing policy on director overboarding.

Prior Policy

Under its prior policy, ISS will recommend a vote AGAINST or WITHHOLD from any individual director who (1) sits on more than six public company boards; or (2) serves as CEO of a public company and sits on the boards of more than two public companies other than the company in which he or she serves as CEO ("outside boards"). In the case of such CEOs, ISS will only issue negative vote recommendations against the director with respect to his or her service on outside boards.

New Policy

As shown in the chart below, ISS has adopted a more stringent policy on overboarding for directors. Starting in 2017, ISS will vote against or withhold from individual directors who sit on more than **five** public company boards. Contrary to its proposed policy update, **ISS has maintained its current policy for directors who are active CEOs of public companies**.

Number of Directorships	Current Policy	New Policy
Individual director (regardless of employment status at the subject company)	No more than 6 directorships	No more than 5 directorships
Director who is an active CEO	No more than 2 outside directorships	No change

Under the new policy, ISS would provide a **one-year grace period (until 2017)** during which time ISS would include cautionary language in its research reports but would not issue a negative vote recommendation solely because a director was considered overboarded under the revised policy.

Meridian Comment. ISS's new policy on overboarding will have little impact on the overwhelming majority of directors. ISS has noted that under the new policy only 61 directors (out of thousands of directors) who do not serve as active CEOs would be considered overboarded, compared to 21 directors under its prior policy.

Glass Lewis has also adopted a more rigid proxy voting policy on director overboarding effective in 2017. Beginning in 2017, Glass Lewis will generally recommend voting against a director based on his or her number of directorships under the following circumstances:

- A director who serves as an executive officer of any public company if he or she serves on a total of **more than two** public company boards; and
- A director who does not serve as an executive officer of a public company if he or she serves on a total of **more than five** public company boards.

In 2016, Glass Lewis' vote recommendations will continue to be based on its existing thresholds (i.e., three total boards for a director who serves as an executive of a public company and six total boards for a director who is not a public company executive). Similar to ISS, however, Glass Lewis will note a concern about any director who sits on excessive boards under its 2017 policy standards for overboarding.

Unilateral Board Actions

ISS is revising its existing policy on unilateral board actions related to the adoption or amendment of charter or bylaw provisions that diminish shareholder rights.

Prior Policy

Under its prior policy, ISS will generally recommend a vote AGAINST or WITHHOLD from directors individually, committee members, or the entire board (except new nominees, who are considered case-by-case) if the board amends the company's bylaws or charter without shareholder approval in a manner that materially diminishes shareholders' rights or that could adversely impact shareholders, considering certain factors ("Unilateral Board Action"). Unilateral Board Actions that ISS considers as materially diminishing shareholder rights include, among other corporate actions, (1) classifying the Board of Directors; and (2) increasing the vote requirement for shareholders to amend charter/bylaws.

ISS's prior policy does not expressly address whether ISS will continue to issue negative vote recommendations on directors in subsequent years if a company's board does not sufficiently address Unilateral Board Action.

New Policy

ISS has revised its policy on Unilateral Board Actions by (1) modifying when such actions could adversely impact shareholders; and (2) distinguishing between Unilateral Board Actions taken by a company prior to or in connection with its IPO ("Pre-IPO") or taken by a company after it is a public company.

Under its new policy, ISS considers as adverse to shareholders' interests the unilateral adoption or amendment of charter/bylaw provisions to:

- Classify the board of directors;
- Establish supermajority vote requirements (this item was added by the new policy); or
- Eliminate shareholders' ability to amend the bylaws (under prior policy, an increase in the vote requirement for shareholders to amend charter/bylaws was considered adverse to shareholders' interests).

ISS's evaluation of the foregoing Unilateral Board Actions differs between those actions taken Pre-IPO or taken by a public company.

- **Post-IPO Amendments**. If a public company undertakes any Unilateral Board Action, ISS will generally issue negative vote recommendations against director nominees (except new nominees, who will be considered case-by-case) until such time as the unilateral action is either reversed or submitted to a binding shareholder vote.
- **Pre-IPO Amendments**. If a company undertakes any Unilateral Board Action Pre-IPO, ISS will generally issue a negative vote recommendation for directors individually, committee members or the entire board (except new nominees, who will be considered case-by-case) at the first annual meeting following completion of the IPO, considering certain factors. In subsequent years, ISS will vote case-by-case on director nominees unless a charter or bylaw provision that is adverse to shareholder rights is either reversed or submitted to a binding shareholder vote.

Meridian Comment. ISS's new policy on Unilateral Board Actions will not affect most public companies as few boards have unilaterally amended their governing documents to reduce shareholder rights (ISS has only identified 62 companies that introduced such amendments in 2015 after becoming public companies).

Shareholder Proposals Requiring Executives to Hold Equity Post-Employment or for a Significant Period of Time

ISS is streamlining its policy on shareholder proposals seeking companies to implement share holding periods or retention ratios.

Prior Policy

Under its prior policy, ISS had separate policies covering shareholder proposals asking boards to adopt policies requiring senior executives to retain (1) 75% of net shares acquired through compensation plans; and (2) a portion of the shares acquired through compensation plans, in each case during a holding period that continued while employed and/or for two years following termination of employment. ISS voted case-by-case on both types of shareholder proposals, taking into consideration certain factors.

New Policy

Under its new policy, ISS will issue vote recommendations on shareholder proposals asking companies to adopt policies requiring senior executive officers to retain a portion of net shares acquired through compensation plans on a case-by-case basis, considering the following factors.

- 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;
- 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
- Problematic pay practices, current and past, which may demonstrate a short-term versus long-term focus.

Meridian Comment. ISS has broadened its policy to encompass executive equity retention proposals more generally, thereby eliminating the need for a separate policy covering proposals seeking retention of a specific retention ratio (i.e., 75% of net shares). In addition, ISS has clarified that a proposed retention ratio and proposed hold period are two of the factors that ISS will consider in its case-by-case evaluation of such proposals.

ISS Provides Additional Guidance on New Voting Policy on Equity Plan Proposals

On November 20, 2015, ISS issued updated guidance on its proxy voting guidelines applicable to equity plan proposals.

In 2015, ISS implemented new proxy voting guidelines applicable to equity plan proposals by evaluating such proposals under an Equity Plan Scorecard ("EPSC"). Under the EPSC, ISS will determine its vote recommendation on such proposals based on the outcome of the following three-part analysis: (i) plan cost; (ii) plan features; and (iii) company grant practices (see Meridian Client Updates dated November 10, 2014 and January 20, 2015 for an overview of the EPSC). Under this three-part analysis, ISS evaluates 13 factors and, based on its evaluation, assigns a point score to each factor. This analysis will yield a specific point score up to a maximum score of 100. Generally, ISS will issue a positive vote recommendation if a company's point score is at least 53.

ISS will apply the new EPSC policies to equity plans subject to shareholder approval at annual meetings occurring on or after February 1, 2016.

The following provides a summary and commentary on this latest guidance.

- **Model Designations and Scoring**: Currently, ISS employs separate scoring models for equity plan proposals from S&P 500, Russell 3000 (excluding S&P 500), Non-Russell 3000 companies and recent IPO/bankruptcy emergent companies. For 2016, ISS has restructured model designations and scoring for companies with ***less than three years of disclosed equity grant data*** (generally, IPOs and bankruptcy emergent companies). Rather than using one "IPO" model for these companies, ISS has created two "Special Cases" models – one for Russell 3000/S&P 500 companies, and another for non-Russell 3000 companies. For affected Russell 3000/S&P 500 companies, ISS has altered its scoring methodology to increase the weight on company grant practices.

- **Vesting of Equity Awards in Connection with a Change in Control (CIC)**. One factor ISS evaluates under its EPSC is the treatment of outstanding non-vested equity awards upon a CIC ("CIC Vesting Factor"). Under its new guidance, ISS significantly clarifies the manner in which it will evaluate this treatment. Specifically, ISS has set forth guidelines under which it will separately evaluate the treatment of time-based and performance-based equity awards in connection with a CIC to determine a company's point score under the CIC Vesting Factor. Described below is the new scoring methodology under the CIC Vesting Factor:

  — **Full points are assigned by ISS** if an equity plan provides for:

  - Either (1) no accelerated vesting of outstanding time-based awards upon a CIC; or (2) accelerated vesting of outstanding time-based awards upon a CIC only if awards are not assumed or converted; **and**

  - Either (1) forfeiture or termination of outstanding performance-based awards upon a CIC; or (2) vesting of such awards based on one of the following:

    – Actual performance through the date of the CIC (paid in full or pro rata) or

    – A guaranteed amount (based on no greater than target performance) paid on a pro rata basis to reflect time elapsed in the ongoing performance period.

  — **Half points** are assigned by ISS if an equity plan provides for vesting terms related to a CIC that differ from the above vesting requirements.

  — **No points** are assigned by ISS if an equity plan provides for either (1) automatic accelerated vesting of time-based awards upon a CIC; or (2) payout of performance-based awards above target level upon a CIC.

- **Post-Vesting/Exercise Holding Period**: Another factor ISS evaluates under its EPSC is a company's share holding requirement applicable to shares obtained by a named executive officer under an equity grant. Under its new guidance, ISS increased the minimum holding period necessary to receive full points for this factor from 12 months to 36 months or until employment termination. ISS will assign half of the full points for a holding period of 12 months.

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