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ISS AND GLASS LEWIS UPDATE THEIR PROXY VOTING GUIDELINES

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Institutional Shareholder Services (ISS) and Glass, Lewis & Co. (Glass Lewis), two of the leading providers of corporate governance research and proxy voting services, have published their updated proxy voting guidelines for 2016. Both companies focused their updates on governance issues, including unilateral bylaw and charter amendments and “overboarding” by directors, as well as compensation, environmental and social issues.

ISS Proxy Voting Guidelines for 2016

The [ISS proxy voting guidelines updates](#) are effective for annual meetings on or after February 1, 2016. ISS released updates for the United States as well as the Canadian, European, and Asian-Pacific markets, but this Alert will focus only on the United States updates.

The most significant updates to the ISS proxy voting guidelines relate to:

- Unilateral bylaw/charter amendments;
- Overboarded directors;
- Proxy Contests/Proxy Access – voting for director nominees in contested elections;
- Insufficient executive compensation disclosure by externally managed issuers (EMIs);
- Policies requiring senior executive officers to hold equity past retirement for a significant period of time; and
- Environmental and social issues (e.g., pharmaceutical pricing and access to medicines, animal welfare and climate change and greenhouse gas emissions).

Unilateral bylaw or charter amendments

In its revisions for the 2015 proxy season, ISS [announced](#) that it would generally recommend voting “against” or “withhold” in elections for existing directors if the board amends the company’s charter or bylaws without shareholder approval in a manner that materially diminishes shareholders’ rights or that could adversely impact shareholders.

While maintaining its stance against unilateral bylaw or charter amendments, ISS has revised its recommendation for 2016 in two ways. First, ISS now explicitly recommends that shareholders consider director nominees on a case-by-case basis in subsequent years after an adverse amendment until the adverse amendment is reversed or submitted to a binding shareholder vote. If the adverse amendment either classified

the board, adopted supermajority vote requirements to amend the bylaws or charter, or eliminated shareholders' ability to amend bylaws, ISS then generally recommends voting "against" directors in all subsequent elections (except for new nominees, who should be considered on a case-by-case basis).

Second, ISS has adopted a slightly different methodology for evaluating unilateral bylaw or charter amendments made prior to or in connection with a company's initial public offering (IPO), recognizing that investors generally have differing expectations for the governance structures of a newly-public company versus a company that has been public for some period of time.

For newly public companies, as with companies that have been public for some time, ISS will generally recommend voting "against" or "withhold" for individual directors, committee members or the entire board (except, potentially, new nominees) if the board amends the company's charter or bylaws without shareholder approval in a manner that materially diminishes shareholders' rights or that could adversely impact shareholders. However, ISS has developed separate factors for shareholders to consider that are unique to newly public companies, including:

- The company's or the board's rationale for adopting the provision;
- 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);
- The ability of shareholders to hold directors accountable through annual director elections, or whether the company has a classified board structure; and,
- A public commitment to put the provision to a shareholder vote within three years of the date of the initial public offering.

However, as with companies that have been public for some period of time, ISS recommends voting "against" the directors of the newly public company on a case-by-case basis in subsequent years unless the adverse provision is reversed or submitted to a vote of public shareholders.

Overboarded directors

ISS has announced that, for meetings on or after February 1, 2017, it will begin recommending a vote "against" or "withhold" for individual directors who sit on more than five public company boards or are CEOs of public companies and sit on the boards of more than two public companies besides their own. This is a change from the existing recommendation of voting against individual directors who sit on more than six public company boards. ISS has revised this recommendation in response to the increasing workload placed upon directors and investor concerns about overboarding.

ISS has indicated that, in 2016, it will note in its analysis if a director is serving on more than five public company boards, but it has provided a one-year transition period to allow affected directors to make changes to their board membership if they so choose.

Proxy Contests/Proxy Access – Voting for director nominees in contested elections

ISS provides an analytical framework for evaluating candidates nominated by shareholders pursuant to previously adopted proxy access bylaws. While proxy access proposals were on the rise in 2015, relatively few companies to date have implemented proxy access bylaws. As a result, even though ISS states that it is unlikely that many (if any) proxy access nominees will materialize in 2016, ISS decided to update the framework for evaluating any such candidates.

Currently, ISS recommends voting on a case-by-case basis for directors in contested elections, considering several factors. The 2016 policy update adds that in the case of candidates nominated through proxy access, just as in contested elections without proxy access nominees, ISS will recommend voting for directors on a case-by-case basis considering various factors, including the background to the contested election, nominee qualifications and any compensatory arrangements, along with any additional factors which may be relevant, including those that are specific to the company, the nominee, or the nature of the election (such as whether or not there are more candidates than board seats).

Insufficient executive compensation disclosure by externally managed issuers

ISS has amended its problematic pay practice policy to add “Insufficient Executive Compensation Disclosure by Externally Managed Issuers (EMIs)” to the list of practices that may result in an adverse recommendation on the advisory vote on executive compensation (the so-called “say-on-pay” vote). Unlike most other companies, an EMI typically does not directly compensate its executives. Instead, executives are compensated by the external manager, which is reimbursed by the EMI through a management fee. According to ISS, EMIs typically do not disclose any details about their compensation arrangements or payments made to executives by external managers. When “executive compensation information” is disclosed, ISS indicates it is usually limited to the aggregate management fee paid by the EMI to its manager.

Such a lack of disclosure has not been previously listed as a problematic pay practice, but ISS considers such disclosures necessary for shareholders to make a reasonable assessment of compensation arrangements. Thus, ISS will generally recommend voting “against” the say-on-pay proposal for EMIs when insufficient compensation disclosure precludes a reasonable assessment of pay programs and practices applicable to the EMI’s executives.

Policies regarding proposals requiring senior executive officers to hold equity past retirement for a significant period of time

ISS currently recommends voting on a case-by-case basis on shareholder proposals asking companies to adopt policies requiring senior executive officers to retain a portion of net shares acquired through compensation plans and to take a series of factors into account in considering such a vote. There is also a separate policy for proposals tied to a specific retention ratio. The updates clarify the factors and establish a much broader policy that encompasses executive equity retention proposals more generally, thus eliminating the need for a separate policy for proposals tied to a specific retention ratio. The updated policy now recommends that shareholders vote on a case-by-case basis for any shareholder proposals asking companies to adopt policies requiring senior executive officers to retain a portion of net shares acquired through compensation plans, taking the following factors into account:

- 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 a long-term focus.

Environmental and social issues

ISS has issued recommendations related to certain proposals regarding environmental and social issues. First, ISS generally recommends voting for proposals seeking a report on a company's animal welfare standards, or animal welfare-related risks, unless certain factors are present. The revised recommendation now clarifies that this policy governs reports on animal welfare-related risks, not just the company's animal welfare standards, and also applies to suppliers' treatment of animals.

Second, ISS recommends voting on a case-by-case basis on proposals requesting that a company report on its pharmaceutical product pricing or access to medicine policies, taking into account certain factors, including potential for reputational, market, and regulatory risk exposure, existing disclosure of relevant policies, deviation from established industry norms, relevant company initiatives to provide research and/or products to disadvantaged consumers, whether the proposal focuses on specific products or geographic regions, the potential burden and scope of the requested report and recent significant controversies, litigation, or fines at the company.

Third, ISS recommends generally voting "for" resolutions requesting that a company disclose information on the risks related to climate change on its operations and investments. The revised recommendation now specifies that the risks related to climate change include financial, physical or regulatory risks.

Glass Lewis Policy Guidelines for 2016

[Glass Lewis updates](#) are generally effective for annual meetings on or after January 1, 2016, and relate to the following areas:

- Conflicting management and shareholder proposals;
- Exclusive forum provisions in a company's governing documents in connection with an IPO;
- Environmental and social risk oversight;
- Nominating committee performance;
- Director overboarding policy; and
- Compensation, specifically one-time and transitional awards.

Conflicting management and shareholder proposals

Glass Lewis has outlined the factors it considers when analyzing conflicting management and shareholder proposals and determining which of the proposals to support. Specifically, Glass Lewis considers:

- The nature of the underlying issue;
- The benefit to shareholders from implementation of the proposal;
- The materiality of the differences between the terms of the shareholder proposal and management proposal;
- The appropriateness of the provisions in the context of a company's shareholder base, corporate structure and other relevant circumstances; and
- A company's overall governance profile and, specifically, its responsiveness to shareholders as evidenced by a company's response to previous shareholder proposals and its adoption of progressive shareholder rights provisions.

Exclusive forum provisions in a company's governing documents in connection with an IPO

Glass Lewis no longer recommends that shareholders vote "against" the chairman of the nominating and governance committee in situations where companies include exclusive forum provisions in their governing documents in connection with an IPO. Instead, Glass Lewis recommends weighing the presence of an exclusive forum provision in a newly public company's bylaws in conjunction with other provisions that, according to Glass Lewis, will unduly limit shareholder rights, such as supermajority vote requirements, a classified board or a fee-shifting bylaw. However, outside of a spin-off, merger or IPO, Glass Lewis will continue to recommend voting against the chairman of the nominating and governance committee when a company adopts an exclusive forum provision without shareholder approval.

Environmental and social risk oversight

Glass Lewis recommends voting "against" directors responsible for risk oversight in situations where the board or management has failed to identify and manage environmental or social risks that could negatively affect shareholder value. This recommendation aligns with Glass Lewis' belief that the identification, mitigation and management of environmental and social risks are integral components of an evaluation of a company's overall risk exposure. Accordingly, Glass Lewis recommends that boards ensure that management conduct a complete risk analysis of the company (including environmental and social risks) and directors should monitor management's performance in managing and mitigating the company's environmental and social risks.

Nominating committee performance

Glass Lewis has indicated that it might now recommend a vote "against" the chair of the nominating committee where the board's failure to ensure the board has directors with relevant experience, either through periodic director assessment or board refreshment, has contributed to a company's poor performance

Director overboarding policy

Like ISS, Glass Lewis is forecasting a change in its director overboarding policy. In 2016, Glass Lewis will "closely review" directors' commitments and may note its concern if a director is serving on more than five total boards, or for a director who serves as an executive of a public company, more than two total boards. In 2017, Glass Lewis will generally recommend voting "against" directors with such commitments. Nonetheless, the

existing thresholds – three total boards for a director that serves as an executive of a public company and six total boards for a director who is not a public company executive – will remain in place for 2016.

Compensation, specifically one-time and transitional awards

Glass Lewis generally recommends that shareholders be wary of awards granted outside of a company's standard incentive scheme, and in analyzing such awards, Glass Lewis has explained that it evaluates several factors, including the current operating environment and the terms and size of the grants in the context of the company's overall incentive strategy and granting practices. Additionally, Glass Lewis indicates that, where a company grants one-time or transitional awards, it should provide a thorough description of the awards, including a "cogent and convincing explanation" of their necessity and why existing awards do not provide sufficient motivation, along with a description of if, and how the regular compensation arrangements will be affected by these additional grants.

Additionally, Glass Lewis also added minor clarifications regarding the quantitative and qualitative factors it uses to analyze equity compensation plans.

If you have any questions about ISS or Glass Lewis updates or if you would like to learn more about the issues covered in this alert, please contact your Smith Anderson lawyer.

Special thanks to **James Jolley**, contributing writer.

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