

Alert

SEC Disclosure and Corporate Governance

Heads Up for the 2016 Proxy Season: ISS Spotlight on Director Overboarding, Unilateral Board Actions and Compensation at Externally-Managed Companies

*ISS Seeks Comment
on Proposed Voting
Policy Changes by
November 9, 2015*

Yesterday, Institutional Shareholder Services released its key draft proposed proxy voting policy changes for the 2016 proxy season. ISS is seeking comments by 6:00 p.m. EDT on November 9, 2015. ISS expects to release its final 2016 policies on November 18, 2015.¹ The policies as updated will apply to meetings held on or after February 1, 2016.

Proposed Amendments to ISS Proxy Voting Policies for 2016

ISS's proposed voting policy changes for U.S. companies would:

- Lower the limit – from 6 to either 5 or 4 public company boards – at which directors (other than a CEO director) will be considered “overboarded”
- Lower the limit – from 2 public company boards to 1 (besides their own) – at which a CEO director will be considered “overboarded”
- Result in a negative recommendation for all director nominees if, without shareholder approval, the board took action to classify the board or establish supermajority vote requirements – the negative recommendation would continue until the unilateral action is either reversed or ratified by shareholders
 - This would even apply to newly public companies that had made such amendments in preparing for their IPO
- Result in a negative say-on-pay recommendation at externally-managed companies (such as REITs) where ISS believes that a comprehensive pay analysis is “impossible” due to insufficient disclosure about compensation arrangements between the executives and the manager

These proposed changes may not be the final word from ISS. ISS cautioned that, in past years, it has announced certain final policy changes that were not presented for draft review. In particular, we note that, although ISS signaled in its 2015-2016 Global Policy Survey that it may take a view on certain restrictions in proxy access bylaws, the proposed policy changes do not address proxy access.² We provide a strategic roadmap for proxy access in our Alert available [here](#).

Director Overboarding – REVISED

Under its existing policy, ISS will issue a negative recommendation for directors that serve on an excessive number of boards. ISS proposes to lower the limit at which it will consider a director overboarded as follows:

	<u>Current Policy</u>	<u>Proposed Revised Policy</u>
All directors (other than CEO)	6 or more public company boards in total (the board under consideration plus 5 others)	Either 5 or 4 public company boards in total (the board under consideration plus either 4 or 3 others)
CEO directors	2 public company boards besides their own (withhold vote only at outside boards)	1 public company board besides their own (withhold vote only at outside boards)

If the new policy is implemented, ISS would offer a one-year transition period during which it would not make a negative recommendation but instead include cautionary language in its proxy voting report about the overboarded director.

According to ISS, this policy update would immediately result in the number of CEOs considered to be overboarded increasing from 79 in the period between July 1, 2014 and June 30, 2015, to 336.³

ISS seeks specific feedback on the following issues:

- Whether lowering the limit for CEOs to be considered overboarded as proposed is appropriate
- Whether lowering the limit for non-CEOs to be considered overboarded as proposed is appropriate and, if so, is a limit of 5 total directorships or 4 total directorships more favorable

Unilateral Board Actions – REVISED

Last year, ISS adopted a new stand-alone policy providing that it will generally issue negative recommendations against directors individually, or against committee members or the entire board (except new nominees, whom it considers 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. The existing policy lists factors that ISS considers when formulating its recommendation, but does not specify for how many years it will issue negative recommendations or what types of amendments it will view as materially diminishing shareholder rights.

For the 2016 season, ISS proposes to amend its policy by explicitly stating that charter and bylaw amendments to (1) classify the board or (2) establish supermajority vote requirements, will result in a negative recommendation for director nominees ***until such time as the shareholders' rights are restored or the unilateral action is ratified by a shareholder vote.***

Spotlight on IPO Companies

While newly public companies have generally faced less scrutiny from ISS, it is now considering adopting a policy of issuing negative recommendations for director nominees at meetings subsequent to the IPO, if the board has unilaterally adopted a bylaw or charter amendment *prior to the IPO* to either classify the board or establish supermajority vote requirements. According to ISS, in 2015 to date, it has issued negative recommendations for director nominees at 21 companies relating to such pre-IPO charter or bylaw amendments.

ISS seeks specific feedback on the following issues:

- Whether there are additional unilateral board actions (other than board classification or implementation of supermajority vote) that are equally problematic in negatively impacting shareholder rights
- Whether, in the IPO context, it is appropriate to hold the directors accountable through continuing adverse recommendations at annual meetings following the IPO for such charter or bylaw amendments

Insufficient Compensation Disclosure at Externally-Managed Issuers – NEW

ISS has expressed concern over the lack of transparency in the compensation disclosure made by externally-managed issuers (EMIs), as well as potential conflicts of interest underpinning such compensation arrangements. EMIs pay fees to an external management firm in exchange for management services and, in most cases, executives of the EMIs are compensated by the external manager. Disclosure is often limited to the aggregate management fees paid by the EMI to the manager. In ISS's view, EMIs typically do not disclose the compensation arrangements and payments made to the EMI executives by the external manager in sufficient detail to enable shareholders to make an informed pay-for-performance evaluation.

Under the proposed policy, ISS would generally recommend a vote “against” a say-on-pay proposal (or, in the absence of a say-on-pay proposal on the ballot, the compensation committee members, the compensation committee chair, or the entire board, as appropriate) in cases where ISS believes that a comprehensive pay analysis is “impossible” because the EMI provides insufficient disclosure about compensation practices and payments made to the executive on the part of the external manager. ISS has not provided guidance on when such analysis would be viewed as “impossible.”

Spotlight on REITs

ISS has said that is aware of 60 externally-managed issuers in the U.S., typically REITs, which in most cases provided limited or no disclosure on executive compensation arrangements with external managers.

ISS seeks specific feedback on the following issues:

- Whether an “against” vote recommendation for an externally-managed company’s say-on-pay proposal is appropriate when the company does not provide sufficient disclosure about executives’ compensation arrangement with the external manager
- What factors ISS should consider in gauging potential conflicts of interest underpinning executives’ compensation arrangement with the external manager
- Are there any unintended consequences that may result from the proposed policy update

What To Do Now?

- Consider providing comments to ISS on the proposed policy changes before the deadline of November 9, 2015. Comments can be submitted to ISS via email to policy@issgovernance.com
- Evaluate whether directors, including the company's CEO, could be at risk to receive a warning or, subsequently, a negative recommendation under the revised ISS overboarding policy
- Companies, including those preparing for an IPO, that are considering whether to amend their charter or bylaws in a manner that could be viewed by ISS to "materially diminish" shareholders' rights or adversely impact shareholders should carefully consider the impact of such amendments
- The compensation committee of an externally managed-issuer should review proxy statement disclosure on compensation arrangements with the external manager and consider whether revisions may be necessary in light of the potential focus on these arrangements by ISS

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If you have any questions on these matters, please do not hesitate to speak to your regular contact at Weil, Gotshal & Manges LLP or to any member of Weil's Public Company Advisory Group:

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We thank our colleague Megan Pendleton for her contribution to this Alert.

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ENDNOTES

1. ISS proposed policy changes, questions for comment and details around how to participate in ISS's comment process are available at: <http://www.issgovernance.com/policy-gateway/2016-benchmark-policy-consultation/>.
2. *See* Institutional Shareholder Services, 2015-2016 ISS Global Policy Survey: Summary of Results (Sept. 28, 2015) available at <http://www.issgovernance.com/iss-releases-results-of-annual-global-voting-policy-survey/>. Other topics addressed in the Survey, but not in the announcement are: director independence "cooling-off" periods; controlled companies; use of adjusted (non-GAAP) metrics in incentive programs; equity compensation of non-employee directors; sunset provisions for NOL poison pills; and use of financial metrics and financial ratios to assess capital allocation decisions, share buybacks and board stewardship.
3. Although all of a CEO's subsidiary boards will be counted as separate boards, ISS will not recommend a withhold vote from the CEO of a parent company board or any of the controlled (>50 percent ownership) subsidiaries of that parent, but may do so at subsidiaries that are less than 50 percent controlled and boards outside the parent/subsidiary relationship.