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ISS Releases its 2016 Policy Survey

ISS's recent Policy Survey previews potential changes in its 2016 proxy voting policies.

Through its annual policy survey, Institutional Shareholder Services (ISS) seeks feedback from institutional investors, public companies and the consulting and legal communities on emerging trends in corporate governance and executive compensation and other matters as part of its policy formulation process. The policy survey often provides an advance read on where ISS is heading on a particular issue.

ISS recently released its 2016 Policy Survey ("Survey"), which includes questions covering non-GAAP performance metrics in incentive compensation programs, proxy access, overboarding and director independence for former executive officers, among many others. These four key categoreis are summarized below.

The Survey will be open for participation until Friday, September 4. The Survey can be completed online by going to the following webpage: https://www.surveymonkey.com/2016 ISS Policy Survey. The results of the Survey are expected to be published in late September. To provide ISS with a corporate perspective, we highly recommend that companies complete the Survey.

Adjusted Performance Metrics in Incentive Compensation Programs

Currently, ISS does not have a specific policy on whether the use of adjusted GAAP performance metrics is appropriate when measuring performance for incentive compensation purposes. The Survey asks whether the use of adjusted or non-GAAP metrics in incentive compensation programs is acceptable. The Survey offers the following potential responses:

- Incentive plan metric results should never be adjusted from reported or GAAP metrics.
- Board-determined adjustments to metrics are acceptable.
- Adjusted metrics are sometimes acceptable, depending on the nature and extent of the adjustments and the degree to which disclosure of their purpose is transparent.

For respondents that answer the foregoing question by selecting the third response above, the Survey asks the respondent to identify the circumstances in which use of non-GAAP metrics is acceptable, offering the following potential responses:

- Non-GAAP metrics are acceptable as long as performance goals and results are clearly disclosed and reconciled with GAAP metrics in the proxy statement, and the reasons for the adjustments are adequately explained.

- Adjustments to GAAP metrics should be described and explained, but do not necessarily need to be fully reconciled to GAAP metrics.

- Non-GAAP metrics should be restricted to commonly used metrics (e.g., funds from operations, EBITDA, etc.)

The Survey also asks whether specific adjustments to GAAP metrics are appropriate, including adjustments to exclude: (1) acquisition expenses, (2) goodwill write-downs or other impairments, (3) compensations expenses, (4) impact of discounted operations, (5) charges deemed non-recurring or extraordinary, (6) impact of foreign exchange volatility, and (7) expenses from lawsuits and related penalties.

Meridian Comment. In recent years, ISS has assessed the rigor of a company's incentive plan performance goals as a component of its qualitative assessment of pay-for-performance alignment. This evaluation may impact ISS's vote recommendation on a company's Say on Pay proposal. We have consistently questioned ISS's ability and competence to make such an evaluation. Nonetheless, ISS appears to be poised to extend this evaluation to the appropriateness of adjusted performance metrics. Again, we believe that ISS is not in a position to substitute its judgment for that of a company's board of directors or compensation committee to determine whether adjustments to performance measures are appropriate to exclude the financial impact of certain items, and how those adjustments are made.

Restrictions on Proxy Access

Under its new policy, ISS will generally recommend FOR a management or shareholder proposal on proxy access if the proposal meets the following requirements:

- Share ownership requirement may not exceed 3% of the outstanding voting securities,

- Share holding requirement may not exceed 3 continuous years for each member of a nominating group,

- Minimal or no limits on the number of shareholders permitted to form a single nominating group, and

- Cap on the number of board nominees of generally 25% of the full board.

If a proxy access proposal sets forth criteria that is more restrictive than the guidelines above, then ISS will generally recommend a vote AGAINST the proposal. ISS will also review the reasonableness of any other restrictions on the right of proxy access in determining whether to support a proxy access proposal.

The Survey asks whether certain types of restrictions adopted by a company's board in response to a majority-supported shareholder proposal on proxy access should be viewed as sufficiently problematic to "call into question the board's responsiveness and potentially warrant 'withhold' or 'against' votes for directors." ISS cites the following nine restrictions as potentially problematic board responses to a majority-supported shareholder proposal on proxy access: (1) an ownership threshold in excess of 3%, (2) an ownership threshold in excess of 5%, (3) an ownership duration greater than three years, (4) an aggregation limit of less than 20 shareholders, (5) a cap on nominees set at less than 20% of the existing board, (6) more restrictive advance notice requirements, (7) information disclosures that are more extensive than those required of the company's nominees, by the company, the SEC, or relevant exchanges, (8) restrictions on compensation of proxy access nominees by nominating shareholders and

(9) re-nomination restrictions in the event a proxy access nominee fails to receive a stipulated level of support or withdraws his/her nomination.

Meridian Comment. As noted in Meridian's Report on Say on Pay and Select Shareholder Proposals for the 2015 Proxy Season dated August 26, 2015, 49 of 85 shareholder proposals seeking proxy access have been approved by shareholders in 2015. The New York City Retirement System submitted the vast majority of these proposals, which were formulated to have ownership requirements and other criteria that complied with proxy advisory firm policies and generally garnered widespread institutional shareholder support. Given the significant number of majority-supported proxy access proposals, unsurprisingly, ISS is now soliciting information to determine the actions that a board should take to implement the proposal in a manner that is responsive to shareholders.

We believe a board should have flexibility in its authority to respond to a majority-supported proxy access proposal as appropriate under the circumstances. However, we do not expect that ISS will adopt a policy that is so onerous that negative ISS vote recommendations based on a purported failure to adequately implement a proxy access proposal will become common.

Overboarding

Under current ISS policy, non-executive directors are considered "overboarded" if they serve on more than six public boards, or in the case of a CEO, more than three public boards including that of the company where he or she is CEO. In such cases, ISS will recommend a vote against the director on that basis if he or she is standing for election. ISS notes that some commentators point to increasing demands on directors' time, as they play a larger role in company and risk oversight, shareholder engagement and other activities, and favor stricter limits on board seats.

In the Survey, ISS asks what constitutes an acceptable number of directorships for non-employee directors, directors who are active CEOs and other directors (e.g., 4, 5 or 6 board seats for non-employee directors and 2 or 3 for active CEOs). ISS also asks whether a stricter standard on the number of directorships should apply to executive directors with "demanding full-time jobs", such as CFOs and law firm partners. Finally, ISS asks whether there should be any exceptions to its standard for excessive directorships for directors' service on boards of non-operating companies or for services by investment holding company executives on boards of publicly-traded companies in which the investment holding company has an interest.

Meridian Comment. ISS appears to be contemplating the adoption of a more stringent standard on overboarding, but may view some situations case-by-case based on a director's other professional time-commitments and/or provide a limited exception where the director's role on the board is part and parcel to other professional responsibilities. As a general matter, the number of board seats that directors hold has declined in recent years, and therefore a new, more stringent ISS policy standard on excessive directorships may only affect a relatively small number of board members.

Director Independence for Former Executives

Under current ISS policy, a former executive (other than a CEO) serving on the board of directors is considered to be a non-independent director for five years from the time the individual held an executive position at the company ("cooling off period"). After the cooling off period lapses, ISS will consider such a director to be independent. The policy applies to an individual who served on the board continuously for the period and to a director who reported to the company's current CEO while the director was an employee of the company. In the Survey, ISS is soliciting input on when the "cooling off period" should start for former executives (e.g., as soon as the individual retires from the executive position, or only after the individual retires from the board as well). ISS also asks whether a cooling-off period should also apply to a former employee of a firm providing significant professional services to the company, such as the company's auditor or outside counsel.

Meridian Comment. Broadening the scope of directors subject to a cooling-off period, coupled with a heightened standard for when the cooling-off period starts for former executives, would result in modest increases in the number of directors being classified as non-independent directors on the basis of a previous employment or professional services relationship with the company. An ISS policy change in this regard may prove problematic for boards seeking to appoint or retain board members who formerly worked as a company executive on the basis that such individuals provide continuity and are familiar with company operations and strategy. A company's board is in the best position to determine the appropriate mix of directors, in consideration of multiple relevant factors about director independence and the breadth of qualifications among board members.

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