SULLIVAN & CROMWELL LLP

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2016 Proxy Season Developments

ISS Announces 2016 Policy Changes and Expected December Release of Proxy Access FAQs; Both ISS and Equilar/Glass Lewis Open Peer Submission Window

SUMMARY

Last Friday, Institutional Shareholder Services ("ISS"), the proxy advisory firm, released its policy changes for the 2016 proxy season. For U.S. companies, the changes include (1) a reduction in the acceptable number of total board seats held by non-CEO directors (with a one-year grace period for implementation), (2) an updated policy regarding negative director recommendations following unilateral or pre-IPO action to classify the board, introduce supermajority voting provisions for bylaw/charter amendments or eliminate the ability of shareholders to amend the bylaws and (3) a recommendation against say-on-pay proposals for externally-managed issuers ("EMIs") who fail to provide the disclosure necessary to allow a comprehensive assessment of pay-for-performance. These changes are generally effective for meetings on or after February 1, 2016, with the grace period for the director overboarding policy ending on January 31, 2017.

There were no new policies on proxy access proposals or board responsiveness. However, in the executive summary of its 2016 policy updates, ISS announced that it will release in December an "FAQ" document that will address which proxy access provisions ISS considers overly restrictive. ISS stated that its fundamental approach to company and shareholder proposals to adopt proxy access remains unchanged. In addition, the ISS policy updates clarify that ISS would evaluate proxy access nominees on a case-by-case basis, considering the same factors as for proxy contest nominees and "additional factors which may be relevant, including those that are specific to the company, to the nominee(s) and/or to the nature of the election," noting that "the circumstances and motivations of a proxy contest and a proxy access nomination may differ significantly. Therefore, it is necessary to create adequate analytical latitude for evaluating candidates nominated through proxy access."

Separately, U.S. companies may submit to ISS and Equilar changes to their compensation peer group for the 2016 proxy season. Any changes submitted to ISS must be submitted between 9:00 AM today and 8:00 PM on December 11th. Any changes submitted to Equilar must be submitted by December 31st. Since July 2012, Glass Lewis & Co. has been using peer groups generated by Equilar in its pay-for-performance analysis.

2016 ISS POLICY CHANGES

Director Overboarding

The first change relates to director overboarding – that is, ISS concerns with directors sitting on an excessive number of boards. Citing concerns "regarding the ability of a director to devote sufficient time to each board commitment," ISS is lowering the number of board positions it considers acceptable for directors who are not currently public company CEOs from six public company boards in total to five public company boards (the board under consideration plus four others). The new policy includes a one-year grace period to give directors the opportunity to come into compliance with the lower limit and will first become effective for meetings on or after February 1, 2017. For 2016, ISS will include cautionary language in their research reports but will not issue a negative vote recommendation solely because a director was overboarded under the revised policy.

ISS determined not to change the threshold at which a public-company CEO will be considered overboarded. That threshold remains at two public company boards, other than the CEO's own company, and any resulting negative recommendation will apply only to directorships other than the CEO's own company.

Unilateral or Pre-IPO Bylaw and Charter Amendments

The second proposal relates to unilateral charter or bylaw amendments, or amendments in connection with an IPO, that aim to classify the board, establish supermajority voting requirements to amend the bylaws or the charter or eliminate the ability of shareholders to amend the bylaws. For established public companies, the updated policy generally calls for continuing to withhold votes from directors who have unilaterally adopted a classified board structure, implemented supermajority voting requirements to amend the bylaws or charter or eliminated the ability of shareholders to amend the bylaws, in each case until the changes are either ratified by shareholders or reversed. Previously, ISS policy provided for an adverse vote recommendation only at the next annual meeting. Note that under the Delaware General Corporation Law, classifying the board and adding a supermajority provision for a charter amendment could not be done without shareholder approval in any event and that the right of shareholders to amend the bylaws cannot be eliminated.

For newly public companies that have adopted provisions adverse to shareholders' rights, with factors including whether there is a classified board or the shareholders' ability to change the existing governance structure is impaired by supermajority voting requirements to amend the bylaws or charter, the updated policy calls for a case-by-case approach with respect to recommendations at subsequent annual meetings. The policy notes that a public commitment by the company to put the adverse provisions to a shareholder vote within three years of the IPO can be a mitigating factor.

Compensation at Externally-Managed Issuers

ISS added insufficient executive compensation disclosure by EMIs as an item that may result in an adverse recommendation on the say-on-pay vote. EMIs, some of which are Real Estate Investment Trusts (REITs), are companies that do not directly compensate their executives, leaving compensation to an external manager who is reimbursed by the EMI through a management fee. EMIs, like other public companies, are subject to advisory say-on-pay voting requirements but may not disclose details of executive compensation arrangements and payments. Concerned with a lack of transparency and shareholders' lack of information, ISS will recommend against EMI say-on-pay proposals "when insufficient compensation disclosure precludes a reasonable assessment of pay programs and practices applicable to the EMI's executives."

Other Changes: Shareholder Proposals on Holding Equity Past Retirement or for a Significant Period of Time and Shareholder Proposals on Environmental and Social Issues

ISS clarified and broadened its recommendation and analysis for shareholder proposals "requiring senior executive officers to retain a portion of net shares acquired through compensation plans." In particular, ISS will evaluate such shareholder proposals on a case-by-case basis under an analysis that applies broadly to executive equity retention proposals and considers the retention ratio and duration among several other factors. This change is intended to "clarif[y] the factors considered . . . [and] broaden[] the policy to encompass equity retention proposals more generally, thereby eliminating the need for a separate policy tied to a specified retention ratio."

ISS also updated its recommendations on shareholder proposals regarding the following environmental and social issues: animal welfare; pharmaceutical pricing, access to medicines and prescription drug reimportation; and climate change and greenhouse gas emissions. ISS expanded its support for shareholder proposals on animal welfare to include proposals relating to both welfare standards and risks and matters relating to the company's suppliers. ISS made slight changes in the factors considered in its case-by-case analysis of shareholder proposals on product pricing or access to medicine policies, "codif[ying] ISS' current practice." ISS also "clarif[ied] the types of risks related to climate change that can impact a company's operations and investments," which include "financial, physical, or regulatory risks."

NO MEANINGFUL GUIDANCE ON PROXY ACCESS

ISS did not provide any additional guidance on shareholder proposals for proxy access or board responsiveness. However, in the executive summary of its 2016 policy updates, ISS announced that it will release in December an "FAQ" document that will address which proxy access provisions ISS considers overly restrictive. ISS states that its fundamental approach to company and shareholder proposals to adopt proxy access remains unchanged. Proxy access proposals have become increasingly popular over the 2014 and 2015 proxy seasons and more companies are independently adopting proxy access bylaws. For more information on proxy access, please see our publications Proxy Access Bylaw Developments and Trends and Proxy Access 2016: Market Trends and Shareholder Proposal Developments.

ISS's policy updates do set forth the methodology it intends to apply for evaluating directors nominated through proxy access. ISS states that it will evaluate proxy access nominees on a case-by-case basis, considering the same factors as for nominees in a proxy contest and will apply any "additional factors which may be relevant, including those that are specific to the company, to the nominee(s) and/or to the nature of the election." The consideration of additional factors is intended to address the different "circumstances and motivations of a proxy contest and a proxy access nomination" and to provide adequate analytical latitude for proxy access nominees.

PEER SUBMISSION WINDOWS OPEN

Both ISS and Glass Lewis take into account a company's self-selected peer group as they develop the peer group that will be used for benchmarking and evaluating the company's executive compensation programs. For ISS, companies in the Russell 3000 Index or Russell MicroCap Index with annual meetings scheduled between February 1, 2016 and September 15, 2016 may submit a new self-selected peer group. Submissions must be made to ISS between 9:00 AM today and 8:00 PM on December 11th, and the peer group submission process can be accessed here: http://www.issgovernance.com/u-s-company-peer-group-feedback.

For Glass Lewis, U.S. companies in the Russell 3000 Index and Canadian companies in the S&P/TSX Composite Index that plan on filing a proxy statement between January 15, 2016 and July 14, 2016 may submit an new self-selected peer group. Submissions must be made to Equilar by December 31st, and Equilar's peer group update portal can be accessed here: https://insight.equilar.com/app/peer_update/. Since July 2012, Glass Lewis has been using peer groups generated by Equilar in its pay-for-performance analysis.

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Sullivan & Cromwell LLP is a global law firm that advises on major domestic and cross-border M&A, finance, corporate and real estate transactions, significant litigation and corporate investigations, and complex restructuring, regulatory, tax and estate planning matters. Founded in 1879, Sullivan & Cromwell LLP has more than 800 lawyers on four continents, with four offices in the United States, including its headquarters in New York, three offices in Europe, two in Australia and three in Asia.

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