ISS and Glass Lewis Release Changes to Their Voting Guidelines for the 2015 Proxy Season

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ISS and Glass Lewis, two influential proxy advisory firms, have both released updates to their policies that govern recommendations for how shareholders should cast their votes on significant ballot items for the 2015 proxy season, including governance, compensation and environmental and social matters.

ISS policy updates are effective for annual meetings after February 1, 2015. We understand that the new **Glass Lewis policies** are effective for annual meetings after January 1, 2015, but clarifications to existing policies are effective immediately.

ISS Policy Updates for 2015 Proxy Season

ISS policy updates should be of particular interest to companies that are opposing shareholder proposals seeking an independent chair for board leadership or asking shareholders to approve equity plans.

Governance Policy Updates

Independent Chair Shareholder Proposals
Perhaps the policy update that will have the most impact is ISS's change to assessing shareholder proposals seeking an independent chair of the board. Prior to this update, ISS looked primarily to whether the board had a lead independent director with robust duties and a company's stock price performance, and the basis for its recommendation was largely straightforward.

The new policy is designed to be more holistic in nature, so that any single factor that may have previously resulted in a *for* or *against* recommendation may be mitigated by other positive or negative factors. Under the new policy, ISS will generally recommend that shareholders vote *for* these proposals, taking into consideration the following:

- The scope of the proposal, including whether it is precatory or binding and whether it is seeking an immediate change or the policy can be implemented at the next CEO transition;
- The company's current board leadership structure, so that ISS may support the proposal under the following scenarios absent a compelling rationale: (a) the presence of an executive or non-independent chair in addition to the CEO; (b) a recent recombination of the role of CEO and chair; and/or (c) a departure from a structure with an independent chair. ISS will also consider any recent transitions in board leadership and the effect such transitions may have on independent board leadership, as well as the designation of a lead director.
- The company's governance structure and practices, including the overall independence of the board, the independence of key committees, the establishment of governance guidelines, board tenure and its relationship to CEO tenure, and any other factors that may be relevant. The evaluation of tenure is at present unclear, but we may get further guidance in the future in the form of FAQs. Governance practices examined include poor compensation practices, material failures of governance and risk oversight, related party transactions or other issues putting director independence at risk, corporate or management scandals and actions by management or the board with potential or realized negative impact on shareholders.
- Company performance, which includes the possible consideration of one-, three- and five-year TSR compared to the company's peers and the market as a whole.

- Any other relevant factors.

ISS indicated that, during the 2014 proxy season, it recommended in favor of more than half of the 62 proposals, and in backtesting the impact of its new policy, ISS expects to support many more shareholder proposals on this topic than it had before. That could make a substantial difference to the overall vote levels. In 2014, only four proposals won majority support.

Boards' Adoption of Bylaw or Charter Amendments without Shareholder Approval

In what is intended to be a codification of its existing practice, ISS will recommend that shareholders vote *against* or *withhold* from directors individually, committee members or the entire board (except new nominees, who should be considered case-by-case) if the board amends the company's bylaws or charter without shareholder approval in a manner that it believes "materially diminish[es] shareholders' rights or that could adversely impact shareholders," considering the following factors:

- The board's rationale for adopting the amendment without shareholder ratification;
- Disclosure by the company of any significant engagement with shareholders regarding the amendment;
- The level of impairment of shareholders' rights caused by the board's unilateral adoption of the amendment;
- The board's track record with regard to unilateral board action on bylaw/charter amendments or other entrenchment provisions;
- The company's ownership structure;
- The company's existing governance provisions;
- Whether the amendment was made prior to or in connection with the company's IPO;
- The timing of the board's amendment to the bylaws/charter in connection with a significant business development; and
- Other factors, as deemed appropriate, that may be relevant to determine the impact of the amendment on shareholders.

Previously, ISS examined unilateral amendments to governance documents as a potential governance failure when reviewing recommendations for director elections. Examples where ISS may have recommended against directors for these actions include situations where a board unilaterally extended the life of a poison pill, or increased the percentage of shares required to call a special meeting.

The commentary notes that the policy is in part a response to the increasing trend of IPO companies adopting "a suite of shareholder-unfriendly governance provisions" and that ISS will consider those IPO-related amendments when determining a recommendation on directors at those companies.

Shareholder Approval of Litigation-Related Provisions

Instead of unilateral adoption by the board, companies may decide to ask shareholders to approve bylaw amendments impacting shareholders' ability to bring suit against the company, including exclusive forum and fee-shifting provisions. ISS will make an assessment of such a company proposal on a *case-by-case basis* that takes into account the following factors:

- The company's stated rationale for adopting such a provision;
- Disclosure of past harm from shareholder lawsuits in which plaintiffs were unsuccessful or from shareholder lawsuits outside the jurisdiction of incorporation;
- The breadth of application of the bylaw, including the types of lawsuits to which it would apply and the definition of key terms; and

- Governance features such as shareholders' ability to repeal the provision at a later date (including the vote standard applied when shareholders attempt to amend the bylaws) and their ability to hold directors accountable through annual director elections and a majority vote standard in uncontested elections.

For many companies, it will be difficult to obtain ISS support if they decide to ask shareholders to approve exclusive forum provisions, since the companies may be unable or unwilling to meet the factor related to disclosure of past harm suffered as a result of these types of suits. In terms of fee-shifting bylaws, ISS will recommend that shareholders vote against the bylaws that mandate fee-shifting whenever plaintiffs are not completely successful on the merits (i.e., in cases where the plaintiffs are partially successful).

Compensation Policy Updates

The key item of change involves equity compensation plans, which ISS will now evaluate under a new Equity Plan Scorecard (EPSC) system. Under what ISS has described as a new, more nuanced scorecard model, ISS will consider multiple factors related to plan cost, plan features and the company's grant practices instead of a simple pass/fail approach.[1]

The new scorecard system considers a range of positive and negative factors, which fall into three broad categories (the EPSC pillars):

1. *Plan cost*. This refers to the total estimated cost of the company's equity plans relative to its industry/market cap peers. ISS will determine plan cost using the company's estimated Shareholder Value Transfer (SVT), which measures the amount of shareholders' equity flowing out of the company to directors and employees. ISS will calculate SVT using two separate measurements:

   a. New shares + shares remaining for future grants + outstanding awards; and

   b. New shares + shares remaining for future grants.

   SVT is expressed as both a dollar amount and as a percentage of market value. We understand that, unless limitations are placed on the most expensive types of awards (i.e., full value awards), the assumption is made that all awards to be granted will be the most expensive type. A plan's SVT will be considered reasonable if it falls below a company-specific allowable cap, which is determined by analysis of the top quartile performers in each industry group, using the Global Industry Classification Standard (GICS), to identify and establish SVT levels for each industry and the performance variables most strongly correlated to SVT. The benchmark industry SVT level is then adjusted upward or downward for the specific company by plugging the company-specific

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[1] Previously, ISS had evaluated equity plans based on six independent pass/fail tests. Under this system, ISS issued an *against* recommendation if the plan failed any one of these tests:

- Is the total cost of the company's equity plans "unreasonable?"
- Is there a pay-for-performance misalignment, and can a significant portion of the CEO's misaligned pay be attributed to non-performance-based equity awards?
- Does the plan permit repricing or exchange of underwater stock options or stock appreciation rights without prior shareholder approval?
- Does the company's three-year burn rate exceed the burn rate cap of its industry group?
- Does the equity plan contain a liberal definition for change in control?
- Is the equity plan a "vehicle" for problematic pay practices?

performance measures, size and cash compensation into the industry cap equations to arrive at the company's specific allowable cap.

2. *Plan features*. This refers to the following factors, which ISS views negatively: (a) automatic single-triggered award vesting upon a change in control; (b) discretionary vesting authority; (c) liberal share recycling on various award types; and (d) minimum vesting period for grants made under the plan.

3. *Grant practices*. This refers to the following factors: (a) the company's three-year burn rate relative to its industry/market cap peers[2]; (b) vesting requirements in CEO equity grants in the prior three years; (c) the estimated duration of the plan (based on the sum of shares remaining available and the new shares requested, divided by the average annual shares granted in the prior three years); (d) the proportion of the CEO's most recent equity grants subject to performance conditions; (e) whether the company maintains a clawback policy; and (f) whether the company has established post-exercise/vesting shareholding requirements.

The weightings of the EPSC pillars will be keyed to each index (the S&P 500, Russell 3000 (excluding the S&P 500), Non-Russell 3000, and Recent IPOs or Bankruptcy Emergent companies). For S&P 500 and Russell 3000 companies, the EPSC pillars will be weighted as follows to calculate the total EPSC score: 45% plan cost, 35% grant practices and 20% plan features. ISS will then issue a recommendation based on the company's total EPSC score. This means that the presence of negative factors will not necessarily give rise to a negative recommendation as long as they are outweighed by sufficient positive factors, and vice versa. Nevertheless, some "highly egregious" features, such as a liberal change-of-control definition or the authority to reprice options without seeking shareholder approval, will still result in automatic *against* recommendations.

ISS plans to provide more information about the EPSC system and the weightings in a compensation FAQ in December.

ISS noted that, with the market recovery, investors "may be more critical" of equity transfers to management without shareholder-friendly plan features and grant practices. It also indicated that its purpose in adopting the new policy is to "expand the range of factors" that investors consider in determining whether an equity plan serves long-term interests.

Environmental and Social Policy Updates

ISS has changed its policy on political contribution shareholder proposals to specify the type of management and board oversight that it reviews. It will generally recommend that shareholders vote *for* proposals requesting greater disclosure on political contributions and trade association spending policies and activities, considering:

- The company's policies, and management and board oversight related to its direct political contributions and payments to trade associations or other groups that may be used for political purposes.
- The company's disclosure regarding its support of, and participation in, trade associations or other groups that may make political contributions, including the comprehensiveness of the trade

[2] It appears that burn rates will also be benchmarked against three indices: the S&P 500, the Russell 3000 (excluding at S&P 500) and the Non-Russell 3000. We understand that the S&P 500 burn rates tend to be significantly lower than the Russell 3000 burn rates. ISS noted that it will develop an additional version of the model for companies that recently IPOed or emerged from bankruptcy, where the burn rate factor does not apply.

association membership disclosure, the nature of the company's participation in trade associations, and the level of transparency surrounding those expenditures.

- Recent significant controversies, fines, or litigation related to the company's political contributions or political activities.

With respect to shareholder proposals seeking the adoption of greenhouse gas (GHG) reduction goals from company products or operations, ISS has clarified its *case-by-case policy* so that it takes into account:

- The company's actual GHG emissions performance.
- Mitigating factors including: (a) whether the company already provides disclosure of year-over-year GHG emissions performance data and (b) the company's current GHG emission policies, oversight mechanisms, and related initiatives.
- Supporting factors including: (a) whether the company disclosure lags behind industry peers and (b) whether the company has been the subject of recent, significant violations, fines, litigation, or controversy related to GHG emissions.

Glass Lewis 2015 Policy Guidelines

The changes made by Glass Lewis are generally incremental, and some are not new policies at all but rather clarifications to existing policies.

Governance Changes

Board Actions on Bylaws

Glass Lewis may recommend that shareholders vote *against* the chair of the governance committee, or the entire committee, if the board amends its bylaws for the following: (a) eliminate the ability of shareholders to call a special meeting or to act by written consent; (b) increase the ownership threshold required for shareholders to call a special meeting; (c) increase the vote requirements for charter or bylaw amendments; (d) adopt provisions that require arbitration of shareholder claims or fee-shifting bylaws; (e) adopt a classified board; or (f) eliminate the ability of shareholders to remove a director without cause.

Board Implementation of Majority-Supported Shareholder Proposals

Like ISS, Glass Lewis will usually recommend that shareholders vote against all members of the governance committee if the board does not act on a shareholder proposal that received majority-support. In determining whether the board has sufficiently implemented the proposal, Glass Lewis will examine the right that the board adopts for any "conditions that may unreasonably interfere with the shareholders' ability to exercise the right (e.g., overly prescriptive procedural requirements for calling a special meeting)."

Vote Recommendations Following IPO

Glass Lewis will recommend that shareholders vote against the governance committee chair if an IPO company adopts an exclusive forum provision, or the entire governance committee if it adopts a fee-shifting bylaw, if those provisions are not put up for shareholder vote after the IPO.

In addition, Glass Lewis will consider recommending a vote against all members of the board who served at the time anti-takeover provisions, such as a poison pill or classified board, was adopted for an IPO company.

Material Transactions with Directors

Glass Lewis clarified that, with respect to its $120,000 threshold for directors employed by a professional services firm where the company pays the firm, not the individual, for services, it may determine that the transaction is immaterial if the amount represents less than 1% of the firm's revenues and the board provides a compelling rationale as to why the director's independence is not affected.

Executive Compensation Changes

Say-on-Pay

One-Off Awards. Glass Lewis has added a new element regarding one-off awards to their say-on-pay analysis. While Glass Lewis indicates that shareholders should generally be wary of awards granted outside of the standard incentive schemes and companies should redesign their compensation programs rather than make additional grants, in certain circumstances these awards may be appropriate.

In those situations, companies 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. Further, such awards should be tied to future service and performance whenever possible. In addition, companies should also describe if and how the regular compensation arrangements will be affected by these supplemental awards. In reviewing a company's use of supplemental awards, Glass Lewis will review the terms and size of the grants in the context of the company's overall incentive strategy and granting practices, as well as the current operating environment.

Qualitative Factors. Glass Lewis also made a slight change to how it describes what happens if a company receives a failing grade from its proprietary pay-for-performance model, which grades companies from "A" to "F". Previously, the proxy advisory firm stated that they may be influenced by significant enhancements that are not identified in a quantitative assessment, without specific details. Glass Lewis now indicates that other qualitative factors, such as an effective overall incentive structure, the relevance of selected performance metrics, significant forthcoming enhancements or reasonable long-term payout levels, could lead to a positive recommendation even when there is a pay-for-performance disconnect.

Employee Stock Purchase Plans

Glass Lewis added to its policy a description of how it examines employee stock purchase plans (ESPPs), using a quantitative model to estimate the cost of the plan by measuring the expected discount, purchase period, expected purchase activity (if previous activity has been disclosed) and whether the plan has a "lookback" feature. It then compare this cost to ESPPs at similar companies. Except for the most extreme cases, Glass Lewis will generally support these plans, given the regulatory purchase limit of $25,000 per employee per year.

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Davis Polk

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