

Client update

ISS AND GLASS LEWIS PUBLISH 2015 PROXY VOTING UPDATES

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Anne C. Meyer
acmeyer@debevoise.com

Alan H. Paley
ahpaley@debevoise.com

Paul M. Rodel
pmrodel@debevoise.com

Institutional Shareholder Services (ISS) and Glass Lewis both released updates to their proxy voting policies last week. Notably, both ISS and Glass Lewis have adopted updates that reflect increased scrutiny of unilateral bylaw amendments that they deem to negatively impact shareholders rights, board leadership structure and compensation-related proposals.

To prepare for the 2015 proxy season, companies should be considering whether the policy updates will impact proxy advisory voting recommendations on key issues, including shareholder proposals, equity plans and corporate governance issues. Thoughtful disclosure, focused shareholder engagement and other strategies are key tools for companies that have sound governance and compensation practices that are not endorsed by the proxy advisory firms or are responding to shareholder proposals in a manner that does not garner their initial support.

The ISS policy updates, which are effective for annual meetings after February 1, 2015, are available on the ISS Policy Gateway at <http://www.issgovernance.com/>. Glass Lewis's voting guidelines, which can be found at <http://www.glasslewis.com/resource/guidelines/>, are generally effective for annual meetings after January 1, 2015.

ISS POLICY UPDATES

The key ISS policy changes for U.S. companies relate to:

- The adoption of bylaw or charter amendments without shareholder approval;
- Independent chair shareholder proposals;
- Litigation rights, particularly exclusive forum and fee-shifting bylaw

provisions;

- Equity-based and other incentive plans; and
- Proposals relating to political contributions and greenhouse gas emissions.

Unilateral Bylaw and Charter Amendments

Under a new policy, which ISS characterizes as a codification of existing practice, if a board amends a company's bylaws or charter without shareholder approval in a manner that ISS believes materially diminishes shareholder rights or could otherwise adversely impact shareholders, ISS will generally recommend voting "against" or "withhold" from individual directors, relevant committee members or the entire board. Previously, ISS would evaluate such changes as a potential material governance failure in the context of director elections.

ISS will consider several factors when determining how to respond to unilateral bylaw and charter amendments, including:

- The board's rationale for adopting the amendment without seeking shareholder ratification;
- Disclosure by the company of any significant shareholder engagement regarding the amendment;
- The level of impairment of shareholders' rights;
- Key governance provisions, including the board's track record on similar actions, the company's ownership structure and existing governance provisions; and
- The timing of the amendment with respect to the company's IPO or a significant business development, if applicable.

While the prevalence of seasoned equity issuers unilaterally adopting what ISS deems to be shareholder-unfriendly governance provisions, such as poison pills or an increased percentage of shares required to call a special meeting, may be low absent unusual circumstances, ISS specifically calls out in its release the adoption of such policies by IPO companies. As a result, the directors of recent IPO companies may face stronger opposition from ISS than was previously the case.

Independent Chair Shareholder Proposals

ISS has adopted what it considers to be a holistic approach to evaluating independent chair proposals. When determining whether to recommend voting “for” shareholder proposals requiring that the chairman position be held by an independent director, ISS will consider a number of factors; no single factor should result in a for or against recommendation. While this analysis may benefit some companies, ISS has indicated that this new approach would have resulted in more ISS support of shareholder proposals during the 2014 proxy season. Any company that is considering challenging an independent chair shareholder proposal should carefully consider ISS’s new approach.

The factors that ISS will consider include:

- The scope of the proposal. ISS will consider whether it is precatory or binding or seeks immediate change in the chairman role prior to the next CEO transition.
- Board leadership structure. Absent a compelling rationale, ISS will support a proposal if there is an executive or non-independent chair, if the company has recently recombined the CEO/chair role or if the company is removing an independent chair. ISS will also consider whether there is a lead director and any recent transitions in board leadership structure.
- Governance structure and practices. ISS will consider board and committee independence, governance guidelines, board tenure and its relationship to CEO tenure and other relevant factors in addition to whether the company has any poor governance practices, including those relating to compensation, material failures of governance and risk oversight, related party transactions or other issues that might impact director independence as well as corporate or management scandals or corporate actions that might have a negative impact on shareholders.
- Company performance. ISS will generally consider one, three and five year total shareholder return (TSR) related to peers and the market as a whole. Strong financial performance may be considered a mitigating factor in considering whether ISS will recommend support of a proposed leadership change.

Litigation Rights

In circumstances where a company seeks shareholder approval of bylaw amendments impacting shareholder litigation rights, rather than unilaterally adopting those amendments, ISS has adopted a new policy under which it will recommend voting on a case-by-case basis considering the following factors.

- The company's rationale for adopting the provision;
- Disclosure of past harm from relevant shareholder lawsuits;
- The breadth of application of the by-law, including the types of lawsuits covered and the definition of key terms; and
- Governance features that permit shareholders to repeal the provision at a later date or to hold directors accountable through annual elections with a majority vote standard in uncontested elections.

ISS will generally recommend a vote against fee-shifting by-laws that apply when plaintiffs are only partially successful. This new ISS policy could create headwinds for companies looking to limit their litigation costs through what ISS deems to be shareholder-unfriendly bylaw provisions.

Equity-Based and Other Compensation Plans

ISS has adopted a new scorecard model for evaluating changes to equity compensation plans. Under this model, ISS will consider a range of positive and negative factors and take what it believes is a more nuanced or holistic approach in contrast to its current pass/fail approach for equity plan proposals.

The scorecard model will look at factors in the following three broad categories (weighted as indicated for the S&P 500 and Russell 3000 companies):

- Plan Cost (45%). The total estimated cost of the company's equity plans relative to industry/market cap peers as calculated using ISS's proprietary Shareholder Value Transfer analysis. ISS will calculate SVT using two separate measurements, one which takes into account new shares and shares remaining for future grants and one which also includes outstanding awards.
- Grant Practices (35%). Practices ISS will review include: (i) the company's three-year burn rate relative to its industry/market cap peers; (ii) vesting requirements in CEO grants for past three years; (iii) estimated duration of the plan (based on the sum of shares remaining available and new shares requested, divided by the average annual shares granted in the prior three years); (iv) the proportion of the CEO's most recent performance-conditioned equity grants and awards; (v) whether the company has a clawback policy; and (vi) whether the company has established post-exercise/vesting shareholding requirements.
- Plan Features (20%). ISS will view several features negatively, including automatic single-trigger award vesting on a change in control, discretionary vesting authority, liberal share recycling on various award types, and

minimum vesting periods for grants made under the plan.

Many of the details about the new scorecard model remain unclear and we understand that ISS plans to issue guidance in the form of compensation FAQs in December. As a general matter, it appears that the scorecard approach will provide ISS more flexibility in evaluating recommendations on plans with both positive and negative factors.

Political Contributions and Greenhouse Gas Emissions

ISS has made clarifications to its voting recommendations for shareholder proposals relating to political contributions and greenhouse gas emissions. ISS will generally recommend voting for proposals requesting greater disclosure on political contributions and trade association spending policies and activities, considering the company's policies, management and board oversight, and existing disclosure. In addition, ISS will consider any recent and significant controversies, fines or litigation related thereto. For proposals seeking the adoption of greenhouse gas reduction goals, ISS clarified that it will evaluate such proposals on a case-by-case basis, taking into account several mitigating and supporting factors relating to the company's existing policies, performance and disclosure.

GLASS LEWIS POLICY UPDATES

Glass Lewis released updates to its policies on governance and executive compensation which are generally incremental.

Unilateral Board Amendments to Bylaws

In instances where a board has amended, without shareholder approval, a company's bylaws in a manner that negatively impacts shareholder rights, Glass Lewis may, depending upon the circumstances, recommend shareholders vote against the chairman of the governance committee or against the entire governance committee. Cited amendments include: (i) eliminating the ability of shareholders to call a special meeting or act by written consent; (ii) increasing the ownership threshold for shareholders to call a special meeting; (iii) increasing vote requirements for charter or bylaw amendments; (iv) adopting provisions that require arbitration of shareholder claims or fee-shifting bylaws; (v) adopting a classified, or staggered, board structure; and (vi) eliminating the ability of shareholders to remove a director without cause.

Responsiveness to Majority-Supported Shareholder Proposals

Glass Lewis will generally recommend that shareholders vote against all directors who were members of the governance committee when the board failed to respond adequately to a shareholder proposal relating to important shareholder rights that receives support from a majority of votes cast. Such shareholder proposals include those relating to declassifying a company's board, establishing a majority vote standard for director elections and providing shareholders the right to call a special meeting. When determining whether a board has sufficiently implemented a shareholder proposal, Glass Lewis will examine the right that the board adopts to determine if there are conditions that may unreasonably interfere with the shareholders' ability to exercise the right. An example cited by Glass Lewis was overly prescriptive procedural requirements for calling a special meeting.

Vote Recommendations Following an IPO

Like ISS, Glass Lewis appears to be increasing its scrutiny of provisions adopted in a company's charter and bylaws prior to an IPO. Glass Lewis will generally refrain from issuing voting recommendations on governance during the one-year following an IPO. However, it will consider recommending a vote against: (i) all board members if an anti-takeover provision such as a poison pill or classified board is adopted and not put to shareholder vote following the IPO; (ii) the chair of the governance committee if an exclusive forum provision is adopted and not put to shareholder vote following the IPO; and (iii) the entire governance committee if a provision limiting litigation rights, such as a fee-shifting bylaw, is adopted and not put to shareholder vote following the IPO.

Material Transactions with Directors

Glass Lewis has a materiality threshold of \$120,000 for transactions with directors employed by a professional services firm where the company pays the firm and not the individual director. The 2015 guidelines clarify that Glass Lewis may determine this amount 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 impacted.

Say-on-Pay

With respect to one-off awards granted outside of existing incentive programs, Glass Lewis has noted that shareholders should generally be wary of such awards, while acknowledging that these one-off incentives may be appropriate in

some circumstances. Glass Lewis indicates that it will review the terms and size of any one-off grants in the context of the company's overall incentive strategy and granting practices, as well as the current operating environment, and provides guidance for companies on providing a thorough description of the awards. The guidance indicates that awards should be tied to future service and performance whenever possible.

Glass Lewis also provides clarification on its approach to say-on-pay analysis, noting that it will consider implementation and effectiveness of a company's executive compensation programs, including pay mix and use of performance metrics in determining pay levels.

Employee Stock Purchase Plans

Except in extreme cases, Glass Lewis will generally support employee stock purchase plans (ESPPs) given the regulatory purchase limit of \$25,000 per employee which Glass Lewis deems reasonable. It has provided additional guidance on its approach to analyzing ESPPs

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Please do not hesitate to contact us with any questions.