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ISS Publishes 2015 Proxy Voting Guideline Updates

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On November 6, 2014, Institutional Shareholder Services Inc. (“ISS”) released the 2015 updates to its benchmark proxy voting policies, having received comments to the draft policies it released on October 15, 2014.¹ The final 2015 policies are substantially similar to the two updates included in the draft policies—the first relating to management equity compensation plan proposals and the second relating to independent board chair shareholder proposals. The 2015 policies also include additional updates relating to litigation rights and certain environmental and social issues. The 2015 policies generally will be effective for shareholder meetings of publicly traded companies held on or after February 1, 2015.²

Management Equity Compensation Plan Proposals

Under its current policies, ISS uses a series of six “pass/fail” tests to evaluate equity plan proposals. For 2015, ISS has adopted a more nuanced approach to evaluate equity share plan proposals, which will consider a range of positive and negative factors related to plan features and historical grant practices. This is referred to as the Equity Plan Scorecard (“EPSC”). The EPSC evaluates three “pillars”—plan cost, plan features and grant practices. A company’s total EPSC score will determine whether a “For” or “Against” recommendation is warranted.

The scorecard factors and weightings will be keyed to company size and status using four index groups: the S&P 500, the Russell 3000 (excluding the S&P 500 companies), non-Russell 3000 companies and recent IPOs.

¹ Our client publication summarizing ISS’s draft policies can be found at: <http://www.shearman.com/~media/Files/NewsInsights/Publications/2014/10/ISS-Publishes-2015-Draft-Policy-Changes-Comments-Due-Oct-29-ECEB-102114.pdf>. Glass Lewis & Co. also released its 2015 proxy guidelines on November 6, 2014. Our client publication summarizing Glass Lewis’s 2015 policies can be found at: <http://www.shearman.com/en/newsinsights/publications/2014/11/2015-proxy-paper-guidelines>.

² The 2014 updates can be found at <http://www.issgovernance.com/file/policy/2015USPolicyUpdates.pdf>.

The following is a summary of the three EPSC pillars:

- **Plan Cost (weighted 45%).**³ The EPSC will review the total potential cost of the company's equity plans relative to its industry/market cap peers, measured by a company's Shareholder Value Transfer ("SVT"). SVT assesses "the amount of shareholders' equity flowing out of the company to employees and directors," expressed as both a dollar amount and a percentage of market value. The 2015 policies measure SVT by both (1) the aggregate of the new shares requested, the shares remaining for future grants and outstanding unvested/unexercised grants and (2) only the new shares requested plus shares remaining for future grants.⁴ This dual cost measurement approach eliminates ISS's current option overhang carve out policy.⁵
- **Plan Features (weighted 20%).** The EPSC will evaluate the following plan features: (1) automatic single trigger vesting upon a change in control, (2) discretionary vesting authority, (3) liberal share recycling on various award types and (4) minimum vesting periods for grants made under the plan. The share recycling provisions will no longer be a component of SVT.
- **Grant Practices (weighted 35%).** The EPSC will consider (1) the company's three year burn rate relative to its industry/market cap peers (this eliminates company "burn rate commitments"), (2) vesting requirements in the three most recent CEO equity grants, (3) the estimated duration of the plan (calculated based on the sum of the shares remaining available and the new shares requested, divided by the average annual shares granted in the prior three years), (4) the proportion of the CEO's most recent equity grants subject to performance conditions, (5) whether the company maintains a clawback policy and (6) whether the company has established post exercise/vesting shareholding requirements.

ISS will recommend a vote "Against" an equity compensation plan proposal if the EPSC score indicates that the plan is not, overall, in the shareholders' interests. The 2015 policies do not specify how this is determined. In addition, notwithstanding a company's EPSC score, certain "highly egregious" features will continue to result in automatic "Against" recommendations including (1) the ability to reprice or implement a cash buyout of underwater options without shareholder approval, (2) vesting of awards based on a liberal change in control definition or (3) problematic pay practices or a pay-for-performance disconnect. Thus, ISS may provide a favorable recommendation for a plan whose cost is nominally higher than the company's allowable cap if sufficient positive factors are present. Conversely, a plan where cost is nominally lower than the allowable cap may receive an "Against" recommendation if a preponderance of the EPSC factors is negative.

³ The specified weightings are applicable to the S&P 500 and Russell 3000 companies only. More information about the policy and weightings will be included in ISS's Compensation FAQs to be published in December.

⁴ Current ISS policies only include one means of calculating SVT—the new share pool proposed, shares available under existing plans and shares granted but unexercised.

⁵ Under ISS's prior policies, companies with sustained positive stock performance and high overhang costs attributable to in the money options that were outstanding for more than six years were able to carve out of these options from the overhang calculation, as long as the dilution attributable to the new share request is reasonable and the company exhibits sound compensation practices.

Unilateral Bylaw/Charter Amendments

ISS's current practice is to evaluate unilateral bylaw/charter amendments under its "Governance Failures Policy." In 2015, ISS adopted a stand-alone policy that codifies the current policy application related to unilateral bylaw/charter amendments under the "Governance Failures Policy."

ISS will generally recommend a vote "Against" or "Withhold" from directors individually, committee members or the entire board if the board amends the company's governance documents without shareholder approval in a manner that materially diminishes shareholders' rights or that could adversely impact shareholders. In performing its analysis, ISS will consider the following factors, as applicable:

- The board's rationale for adopting the bylaw/charter 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 amendment to the bylaws/charter;
- 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 initial public offering;
- 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.

Independent Board Chair Shareholder Proposals

Under its current policy, ISS will generally recommend a vote "For" shareholder proposal for independent chairs unless the company maintains a certain specific counterbalancing governance structure. This method of evaluation requires that the company satisfy all of the criteria on ISS's list.

In 2015, ISS has added new governance, board leadership and performance factors to the list of criteria considered when evaluating shareholder proposals for independent chairs, including:

- Absence/presence of an executive chair;
- Recent board and executive leadership transitions at the company;
- Director and CEO tenure; and
- Longer (five year) TSR performance period.

ISS's new policy is to vote "For" shareholder proposals requiring that the chairman's position be filled by an independent director, taking into consideration the following:

- The scope of the proposal;
- The company's current board leadership structure;

- The company's governance structure and practices; and
- Any other relevant factors that may be applicable.

Similar to the EPSC policy, ISS has adopted a more holistic approach in evaluating these types of proposals. Therefore, a "For" or "Against" recommendation will not be determined by any single factor. Rather, ISS will consider all positive and negative aspects of the company based on the new expanded list of factors when assessing these shareholder proposals.

Litigation Rights

For 2015, ISS expanded its policy on exclusive venue provisions to cover other types of bylaws that have a material impact on shareholders' litigation rights, including bylaws that mandate fee-shifting or arbitration. ISS will evaluate these bylaws on a case-by-case basis, taking into account factors such as:

- The company's stated rationale for adopting such a provision;
- Disclosure of past harm from shareholder lawsuits in which plaintiffs were unsuccessful or 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.

We note, however, that ISS will generally recommend "Against" bylaws that mandate fee-shifting in cases where plaintiffs are not completely successful on the merits.

Political Contributions

ISS has also refined its policies relating to political contributions shareholder proposals. ISS will vote for proposals requesting greater disclosure of a company's 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; and
- Recent significant controversies, fines or litigation related to the company's political contributions or political activities.

The overall purposes of the revised policy are to (1) specify the types of oversight mechanisms (i.e., management and board oversight) that ISS will review and consider when applying the policy for greater clarity and (2) reflect the evolution of corporate disclosure practices on political contributions that has taken place in recent years. When reviewing disclosures of trade association support or participation, ISS will look at the comprehensiveness of a company's trade association membership disclosure, the nature of a company's trade association participation, the level of transparency provided regarding a company's trade association expenditures and other relevant factors.

Greenhouse Gas Emissions

ISS notes that during the 2014 proxy season, the most prevalent resolutions on climate change requested companies to adopt goals to reduce their greenhouse gas emissions. Twenty-one of these resolutions were submitted in 2014 as compared to four in 2013 and nine in 2012. Eleven of these proposals submitted in 2014 were withdrawn by their sponsors and nine resolutions went to a vote. ISS anticipates that even more greenhouse gas emissions proposals will be submitted on a going-forward basis. In this regard, ISS has updated its policies to provide greater clarity on the factors that are considered in its analysis of greenhouse gas-related proposals. Under the revised policy, ISS will make recommendations on a case-by-case basis on proposals that call for the adoption of greenhouse gas reduction goals from products and operations, taking into account the following considerations:

- Whether the company provides disclosure of year-over-year GHG emissions performance data;
- Whether company disclosure lags behind industry peers;
- The company's actual greenhouse gas emissions performance;
- The company's current greenhouse gas emission policies, oversight mechanisms and related initiatives; and
- Whether the company has been the subject of recent, significant violations, fines, litigation or controversy related to greenhouse gas emissions.

Conclusion

As was the case in 2014, ISS has not adopted sweeping changes to their 2015 policies; however, the proposed modifications reflect movement away from rigid policies towards a more flexible, holistic approach.

ISS will issue frequently asked questions on the EPSC in December. The EPSC is not designed to increase or decrease the number of companies receiving negative vote recommendations; however, companies that will be placing equity plans up for shareholder approval in 2015 must consider whether the EPSC will alter expected ISS recommendations and, consequently, whether plan modifications will be required. In reviewing their plans, companies should pay particular attention to outlying terms which have historically not presented impediments to a positive ISS recommendation.

ISS notes that its 2015 policy is intended to address the recent substantial increase in bylaw/charter amendments that adversely impact shareholder rights without being subject to a shareholder vote, and is in line with investor sentiment that the board should never adopt amendments that negatively impact investor's rights without shareholder approval. Companies that intend to adopt any corporate governance policies that adversely impact shareholder rights should consider seeking shareholder support before implementing such policies. ISS has taken a similar approach in the IPO context, and, therefore, companies should seek shareholder ratification of pre-IPO amendments that have a similar adverse effect on shareholder rights.

Despite the year-over-year increase in the number of independent chair proposals, these proposals have not received significant shareholder support. Under its prior evaluation approach, ISS recommended against approximately 50% of these proposals in 2014. However, ISS notes that the testing of its new methodology indicates a higher level of support for independent chair proposals in 2015, which will likely have a positive impact on shareholder support. Companies with independent chair proposals on their 2015 ballots should consider how ISS's shift in focus to the governance, board leadership and financial performance factors will affect shareholder support for these proposals.

In connection with a recent uptick in the adoption of fee-shifting bylaws following last year's Delaware Supreme Court decision in favor of such actions, ISS has attempted to set out a framework for evaluating bylaws that impact shareholder litigation rights. Companies that are planning to adopt these types of bylaws, whether unilaterally or by shareholder vote, should consider including appropriate limitations based on the criteria that ISS will consider, as summarized above.

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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