



## On the Subject

### ISS and Glass Lewis Update Proxy Voting Guidelines for 2015

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Institutional Shareholder Services Inc. (ISS) and Glass, Lewis & Co., LLC, issued their respective annual updates to their proxy voting guidelines on November 6, 2014. As revised these guidelines have important implications for companies preparing for the 2015 proxy season.

#### ISS Policy Updates

The [annual U.S. policy update](#) reflects changes in ISS's approach towards the evaluation of the following items:

- Executive compensation, including ISS's adoption of a new Equity Plan Scorecard
- Independent chair shareholder proposals
- Unilateral bylaw or charter amendments
- Litigation rights, including exclusive venue and fee-shifting bylaw provisions
- Proposals relating to a company's political contributions and trade association spending policies and activities
- Proposals relating to greenhouse gas emissions

Additional details are expected in December 2014 when ISS issues FAQs on its new policy.

#### EQUITY COMPENSATION PLANS

ISS has significantly changed the focus of its guidelines with respect to when it will recommend "for" or "against" an equity plan proposal. Public companies submitting equity plan proposals during the 2015 proxy season for shareholder approval will need to understand these changes when designing and drafting plan features and preparing the related proxy proposal. Public companies that are not in the *Fortune* 500 also have a new opportunity to corroborate with ISS data related to an equity plan proposal.

Historically, ISS used a series of pass/fail tests relating to the cost of the equity plan proposal, including such items as the ISS shareholder value transfer (SVT) and burn rates; executive compensation practices considered to be egregious, such as golden parachute excise tax gross-ups, liberal change in control protections and pre-approval of future re-pricings; and serious misalignment between CEO pay and company performance. Failure to meet any one of these tests resulted in an "against" voting recommendation by ISS.

The revised guidelines replace these pass/fail tests with a more flexible approach based a series of factors related to plan cost, plan features and equity grant practices. According to revised guidelines, ISS will "vote case-by-case on equity-based compensation plans depending on a combination of . . . [factors], where positive factors may counterbalance negative factors, and vice versa." Specifically, the new policy provides for ISS to use a so-called Equity Plan Scorecard (EPSC) that will result in an overall score with respect to an issuer's equity plan proposal.

ISS has not revealed what level of score will be required for a company to receive a “for” voting recommendation. The relative weighting of factors for public companies in the S&P 500 and Russell 3000, however, are available:

- 45 percent for plan costs (*e.g.*, SVT against market and industry peers based on new requested shares, shares remaining for future grant and outstanding grants that have not resulted in an issuance of shares)
- 20 percent for plan features (*e.g.*, change in control vesting, share recycling provisions and minimum vesting periods)
- 35 percent for grant practices (*e.g.*, burn rates, the relative weighting of performance-based grants, clawback policies and required stock holder periods for shares issued under an equity award)

This weighting for public companies in the S&P 500 and Russell 3000 appears to reflect the responses to an ISS survey supporting a scorecard approach that places more emphasis on plan features and grant practices, as opposed to plan cost only. ISS has not yet announced weightings for non-S&P 500 or -Russell 3000 companies.

It remains to be seen whether this more flexible approach will actually result in ISS issuing more favorable voting recommendations for equity plan proposals than under its prior guidelines. ISS did not indicate what impact this more flexible approach would have had if it had been in effect in prior years.

Notable features of the new approach include the following:

- Share recycling provisions (*i.e.*, when shares are added back to the share reserve). Liberal share recycling provisions (*e.g.*, adding back shares used to pay tax withholding or the exercise price for stock options) will now be taken into account as a plan feature under the new EPSC approach, and not in determining plan cost.
- SVT calculations. Calculations will include and disregard the potential dilution that would result from existing unvested and unexercised equity awards. This distinction may be particularly relevant for a public company with significant amounts of overhang.

- Clawback policy/required holding period. Issuers without these grant practices may want to consider adding them before submitting an equity plan proposal, because these factors are now being assigned a formal weight as part of the EPSC.

U.S. public companies presenting management proposals generally will want to tailor them to provide disclosure addressing each EPSC element. It is anticipated that ISS will provide additional information regarding its EPSC when it issues its FAQs in December or subsequently.

U.S. public companies should consider using the new data verification portal offered by ISS for equity plan proposals. The portal provides an opportunity for companies to corroborate with ISS that they have correct data when preparing their EPSCs. Data that can be confirmed with ISS includes prior grant activity, equity plan provisions and share reserves. A full list of the data that can be verified with ISS, how to register and other frequently asked questions is available [here](#).

#### INDEPENDENT CHAIR SHAREHOLDER PROPOSALS

Noting that proposals for independent board chairs were the most common shareholder proposal presented at the annual meetings of U.S. public companies in the 2014 proxy season, ISS has revised its “Generally For” policy on these proposals by adding new governance, board leadership and performance factors to its analysis, providing for a holistic approach considering all relevant factors. ISS will take into consideration the company’s governance structure and practices, the current board leadership structure, the company’s performance, the scope of the proposal and any other factors it considers relevant.

Problematic governance practices may 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.

Regarding the company's board leadership structure, the revised policy states that ISS may support the proposal where it does not find a compelling rationale for the following scenarios: the presence of an executive or non-independent chair in addition to the CEO, a recent recombination of the role of CEO and chair, and/or 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 role.

ISS's performance assessment will generally consider one-, three- and five-year total shareholder return (TSR) compared to the company's peers and the market as a whole. While poor performance will weigh in favor of the adoption of an independent chair policy, strong performance over the long term will be considered a mitigating factor when determining whether the proposed leadership change warrants support.

Regarding the scope of the proposal, ISS will consider whether the proposal is precatory or binding, and whether the proposal seeks an immediate change in the chairman role or the policy can be implemented at the next CEO transition.

In addition to the holistic review summarized above, the revised policy states that ISS will generally recommend a vote for shareholder proposals requiring that the chairman's position be filled by an independent director, unless the company satisfies all of the following criteria:

- The company must maintain a counterbalancing governance structure consisting of the following:
  - A designated lead director, elected by and from the independent board members with clearly delineated and comprehensive duties, including specific duties specified in the updated policy
  - A two-thirds independent board
  - Fully independent key committees
  - Established governance guidelines
- A company in the Russell 3000 universe must not have exhibited sustained poor TSR performance, as defined in the guidelines, unless there has been a change in the chairman/CEO position within that time.

- A non-Russell 3000 company must not have underperformed both its peers and index on the basis of both one-year and three-year TSR, unless there has been a change in the chairman/CEO position within that time.
- The company must not have any problematic governance or management issues, such as those described above.

#### UNILATERAL BYLAW/CHARTER AMENDMENTS

Because of a substantial increase in the number of bylaw and charter amendments without shareholder approval or ratification that adversely affect shareholder rights, and in response to what ISS reported as strong investor sentiment that a board should never adopt amendments that negatively affect investors' rights without shareholder approval, ISS has adopted a stand-alone policy with respect to unilateral bylaw or charter amendments that codifies the current policy application related to such proposals under ISS's more general "Governance Failures" policy.

Under the new stand-alone policy, ISS will generally recommend a vote against or withhold from directors individually, committee members or the entire board (except new nominees, who will be considered case-by-case) if the board amends the company's bylaws or charter without shareholder approval in a manner that materially diminishes shareholders' rights or that could adversely affect shareholders, considering the following factors:

- 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 or charter amendments or other entrenchment provisions
- The company's ownership structure
- The company's existing governance provisions
- The timing of the board's amendment to the bylaws charter in connection with a significant business development
- Other factors, as deemed appropriate, that may be relevant to determine the impact of the amendment on shareholders

ISS states that because some investors prefer to consider pre-IPO adoptions of shareholder-unfriendly provisions on a case-by-case basis, the revised policy addresses IPO-related amendments by considering that context as a factor when determining a vote recommendation on directors.

#### LITIGATION RIGHTS (INCLUDING EXCLUSIVE VENUE AND FEE-SHIFTING BYLAW PROVISIONS)

Board adoption of bylaw provisions that affect shareholders' litigation rights without shareholder approval or ratification will be evaluated under ISS's policy on Unilateral Bylaw/Charter Amendments.

As to proposals regarding such matters, ISS has not previously had a policy on fee-shifting bylaw provisions (which typically require a shareholder who sues a company unsuccessfully to pay all litigation expenses of the defendant corporation). Its policy on exclusive forum bylaw provisions (which provide that the state of incorporation shall be the sole venue for certain types of litigation) has been to review them case-by-case, taking into account whether the company has been materially harmed by shareholder litigation outside its jurisdiction of incorporation based on disclosure in the company's proxy statement, and whether the company has the following good governance features:

- An annually elected board
- A majority vote standard in uncontested director elections
- The absence of a poison pill, unless the pill was approved by shareholders

The revised ISS policy is to take a case-by-case approach on formulating a recommendation on proposed bylaw amendments that affect shareholders' litigation rights, taking into account factors such as the following:

- 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

- 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

The revised ISS policy is to generally recommend a vote against bylaws that mandate fee-shifting whenever plaintiffs are not completely successful on the merits (*i.e.*, in cases where the plaintiffs are partially successful).

ISS's policy updates note that its policy on litigation rights is meant to anticipate the possibility that, absent possible action by the Delaware legislature, a large number of companies might adopt such bylaws in 2015 and beyond, either through unilateral board action or by putting such provisions to a shareholder vote, and also may adopt other types of bylaws affecting litigation rights, including provisions that would mandate arbitration instead of litigation, and provisions that would require a plaintiff to demonstrate that his or her case is supported by a significant number of other shareholders in the company.

#### PROPOSALS RELATING TO POLITICAL CONTRIBUTIONS AND TRADE ASSOCIATION SPENDING AND ACTIVITIES

With regard to proposals requesting greater disclosure of a company's political contributions and trade association spending policies and activities, the revised policy is to generally recommend a vote "for," considering the following:

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

The updated policy specifies the types of management and board oversight mechanisms that ISS reviews and considers when applying the policy. In addition, the revised ISS policy states that information that will be incorporated into reviews of disclosures of trade association support or participation will



include, among other things, the comprehensiveness of a company's trade association membership disclosure, the nature of a company's trade association participation and the level of transparency provided regarding a company's trade association expenditures.

#### PROPOSALS RELATING TO GREENHOUSE GAS EMISSIONS

The revised policy recommends voting case-by-case on proposals that call for the adoption of greenhouse gas (GHG) reduction goals from products and operations, taking into account the following factors:

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

ISS notes in the policy update that most investor and issuer respondents to a survey it conducted indicated that company disclosure of a robust set of environmental and social policies, oversight mechanisms and related initiatives, and company disclosure of environmental and social performance data for a multi-year period can be mitigating factors. Accordingly, the updated policy also provides greater detail on the factors that are considered in ISS's analysis of GHG-related proposals.

### Revised Glass Lewis Guidelines

[Click here](#) to access the revised Glass Lewis guidelines for the 2015 proxy season.

#### EXECUTIVE COMPENSATION

The revised guidelines include clarification regarding Glass Lewis's approach to say-on-pay analysis and a discussion of its approach to analyzing one-off awards granted outside of existing incentive programs. With regard to say-on-pay proposals, the revised policy adds as an area of focus the implementation and effectiveness of the company's executive

compensation programs, including pay mix and use of performance metrics in determining pay levels. Under issues that may cause Glass Lewis to recommend voting against a say-on-pay vote, the firm replaced "guaranteed bonuses" with "problematic contractual payments, such as guaranteed bonuses." The revised guidelines include new qualitative factors that may result in a "for" vote recommendation even if the company failed under the Glass Lewis proprietary pay for performance model. These factors include effective overall incentive structure, relevant performance metrics and reasonable long-term payout levels.

With regard to one-off awards, the revised guidelines acknowledge that while they can in certain cases be appropriate, one-time awards might also undermine the integrity of the underlying incentive program. When such awards have been made, Glass Lewis will consider the disclosed rationale for the award, the rationale for why existing awards do not provide adequate incentive, whether the award is tied to future service and performance conditions, and whether other compensation arrangements will be affected by the supplemental awards.

#### EMPLOYEE STOCK PURCHASE PLANS

The revised Glass Lewis policy adds a discussion of its approach to analyzing employee stock purchase plans (ESPPs). Glass Lewis generally views such plans favorably because it believes they provide employees with a sense of ownership in the company and strengthen the alignment between employees and shareholders. Glass Lewis uses a quantitative model to estimate the cost of an ESPP, which it compares to the cost of ESPPs at similar companies, measuring the expected discount, the purchase period, and other features of the plan and anticipated activity. Glass Lewis will look at the number of shares requested to evaluate the ESPP's impact on shareholder dilution and consider whether shareholders will not have an opportunity to approve the plan for an excessive period of time. Accordingly, it will generally recommend a vote against a proposed ESPP that contains "evergreen" provisions that automatically increase the number of shares available under the ESPP each year. Otherwise, except in extreme cases adverse to shareholder interest, Glass Lewis will generally recommend in favor of ESPPs.

#### **GOVERNANCE COMMITTEE PERFORMANCE**

The revised Glass Lewis guidelines include a new policy regarding instances where a board has amended the company's governing documents to reduce or remove important shareholder rights, or to otherwise impede the ability of shareholders to exercise such rights, and has done so without shareholder approval. In these cases, depending on the circumstances, the Glass Lewis policy is to recommend that shareholders vote against the chairman of the governance committee, or against the entire committee.

Examples of board actions that may cause such a recommendation include the elimination of the ability of shareholders to call a special meeting or to act by written consent; an increase to the ownership threshold required for shareholders to call a special meeting; an increase to vote requirements for charter or bylaw amendments; the adoption of exclusive forum provisions; the adoption of provisions that limit the ability of shareholders to pursue unlimited, full legal recourse, such as provisions that require arbitration of shareholder claims or "fee-shifting"; the adoption of a classified board structure; and the elimination of shareholders' ability to remove a director without cause.

#### **BOARD RESPONSIVENESS TO MAJORITY-APPROVED SHAREHOLDER PROPOSALS**

Glass Lewis will generally recommend that shareholders vote against all members of the governance committee when a shareholder proposal relating to important shareholder rights received support from a majority of the votes cast (excluding abstentions and broker non-votes) and the board failed, in Glass Lewis's view, to adequately respond. Such shareholder proposals include those seeking board declassification, majority voting for directors and a right to call a special meeting, among other things. The revised policy specifies that in determining whether a board has sufficiently implemented such a proposal, Glass Lewis will consider any conditions that may unreasonably interfere with the shareholders' ability to exercise a proposed shareholder right (for example, the revised policy notes, overly prescriptive procedural requirements for calling a special meeting).

#### **STANDARDS FOR ASSESSING "MATERIAL" TRANSACTIONS WITH DIRECTORS**

With regard to Glass Lewis's \$120,000 threshold for those directors employed by a professional services firm, such as a law firm, investment bank or consulting firm, where the company pays the firm, not the individual, for services, the revised policy clarifies that Glass Lewis may deem such a transaction to be immaterial where the amount represents less than 1 percent of the firm's annual revenues and the board provides a compelling rationale as to why the director's independence is not affected by the relationship.

#### **VOTE RECOMMENDATIONS FOLLOWING IPO**

The revised guidelines provide that Glass Lewis will scrutinize certain provisions in the company's charter or bylaws adopted prior to an IPO. Specifically, it will consider recommending to vote against all members of the board who served at the time of the adoption of an anti-takeover provision, such as a poison pill or classified board, if the provision is not put up for shareholder vote following the IPO. Additionally, consistent with its general approach to boards that adopt exclusive venue provisions or fee-shifting bylaws without shareholder approval, Glass Lewis will recommend that shareholders vote against the governance committee chair in the case of exclusive forum provisions, and against the entire governance committee in the case of fee-shifting provisions, if they are not put up to a shareholder vote following the IPO.

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