HUNTON& WILLIAMS

Client Alert

November 2014

ISS and Glass Lewis Release Updates to Their Proxy Voting Guidelines

Institutional Shareholder Services ("ISS") and Glass, Lewis & Co. ("Glass Lewis") recently announced updates to their respective voting policies for US companies for the 2015 proxy season. The ISS and Glass Lewis policy updates are effective for annual meetings on or after February 1, 2015, and January 1, 2015, respectively.

We have summarized below the most important updates relating to corporate governance matters that may be of interest to US companies as they prepare for the 2015 proxy season.

ISS 2015 Proxy Voting Guideline Updates

Independent Chair Shareholder Proposals

The most notable ISS policy change relates to shareholder proposals seeking to separate the chairman and CEO positions. ISS points out in its policy that calls for independent board chairs were the most prevalent type of shareholder proposal during the 2014 proxy season. (As of June 30, 2014, 62 of these proposals were brought to a shareholder vote and such proposals received an average support of 31.2% of votes cast at the 2014 meetings. Four of these 62 proposals received the support of a majority of votes cast.)

Under its prior guidelines, ISS recommended "for" such shareholder proposals unless the company maintained certain "counterbalancing governance" features, such as a designated independent lead director with clearly delineated duties, two-thirds independent board, fully independent key committees and established governance guidelines.

Under its new policy, ISS will generally recommend that shareholders vote "for" proposals to separate the chairman and CEO positions after taking into consideration the following factors, as well as any other relevant factors that may be applicable:

- *Scope of the Proposal*: ISS will consider whether the proposal is precatory or binding and whether the proposal is seeking an immediate change in the chairman role or whether it can be implemented at the next CEO transition.

- *Company's Current Board Leadership Structure*: ISS may support the proposal under the following scenarios absent a compelling rationale:

    - the presence of an executive or non-independent chairman in addition to the CEO;

    - a recent recombination of the role of CEO and chairman; and/or

    - departure from a structure with an independent chairman.

- *Company's Governance Structure*: ISS will consider the overall independence of the board, the independence of key committees and the establishment of governance guidelines, board tenure and its relationship to CEO tenure, among other relevant factors.

- *Company's Governance Practices*: ISS may review the following governance practices, among others: 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 impacts on shareholders.

- *Company Performance*: ISS will generally consider one-, three- and five-year total shareholder return compared to the company's peers and the market as a whole.

Although ISS states that its new policy is an attempt to take a more "holistic" approach, in practice, it will likely result in more "for" recommendations to shareholder proposals seeking to separate the chairman and CEO positions. During the 2014 proxy season, ISS recommended in favor of more than half of those proposals, but in backtesting the impact of its new policy ISS indicates that the new policy would have resulted in a higher level of support for the independent chair proposals than the prior policy.

Unilateral Bylaw/Charter Amendments – Voting on Director Nominees

ISS has adopted a stand-alone policy that is intended to codify its current policy related to unilateral bylaw/charter amendments. Under the new policy, ISS will generally recommend that shareholders "withhold" or vote "against" directors individually, committee members or the entire board 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 impact shareholders." ISS will consider the following factors:

- 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 existing governance provisions;

- whether the amendment was made prior to or in connection with the company's initial public offering ("IPO");

- the timing of the board's amendment to the bylaws/charter in connection with a significant business development; and

- other factors that may be relevant to determine the impact of the amendment on shareholders.

ISS did not include specific details in its policy with regard to what kinds of amendments would be problematic. The policy update notes that a rationale for the update is the recent substantial increase in the number of bylaw/charter amendments made by boards that adversely impact shareholder rights without seeking shareholder ratification, including the recent trend of companies adopting a suite of shareholder-unfriendly governance provisions shortly before, or on the date of, an IPO.

Because boards typically lack the power to amend a charter unilaterally in any material way, this policy will generally be used to review bylaw amendments, subject to the specific policy relating to shareholders' litigation rights discussed below.

Bylaw Amendments Affecting Shareholders' Litigation Rights

ISS has expanded its policy on bylaw amendments that have a "material impact" on shareholders' ability to bring suit against the company, including exclusive forum bylaws, "fee-shifting" bylaws, and bylaws that require arbitration of shareholder claims. ISS will assess such amendments 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 the 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 contested elections.

ISS generally recommends voting "against" shareholder- or management-sponsored proposals seeking approval of bylaws that mandate "fee-shifting" when plaintiffs are not completely successful on the merits.

Equity-Based Compensation and Other Incentive Plans

ISS adopted an Equity Plan Scorecard ("EPSC") that considers a range of positive and negative factors in evaluating equity incentive plan proposals. The total EPSC score will generally determine whether ISS recommends "for" or "against" the proposal. This is a significant change from the six pass/fail tests focused on cost and certain egregious practices previously used by ISS to evaluate such proposals. Under its old policy, ISS would issue an "against" recommendation if the plan failed any one of the tests.

The updated policy will, among other things, (i) use three index groups to determine burn-rate benchmarks and factor weightings (S&P 500, Russell 3000, Non-Russell 3000 (collectively, the "index groups")),[1] (ii) use individual scorecards for each of the index groups and for IPOs, (iii) eliminate option overhang carve-outs (due to the updated Shareholder Value Transfer ("SVT") calculation below), and (iv) eliminate consideration of "liberal share recycling" provisions from the SVT cost calculations (share recycling will be scored as a negative plan feature).

Under its new policy, ISS will evaluate equity-based compensation plans on a case-by-case basis depending on a combination of certain plan features and equity grant practices, as evaluated by the EPSC factors. The EPSC factors will fall under the following three categories ("EPSC Pillars"):[2]

[1] ISS will develop another version of the model for companies that recently completed an IPO or emerged from bankruptcy, where the burn-rate factor does not apply.

[2] The weightings listed for each EPSC Pillar are for S&P 500 and Russell 3000 companies. The weighting percentages for non-Russell 3000 companies and IPO companies were not provided, but ISS advised that additional guidance on the EPSC factors will be included in ISS's Compensation FAQ to be published in December 2014.

- *Plan Cost (45% weighting)*: The total estimated cost of the company's equity plans relative to industry/market cap peers. ISS will measure plan cost by the company's estimated SVT in relation to peers. The SVT calculation assesses the amount of shareholders' equity flowing out of the company to employees and directors. ISS will calculate SVT based on both:

    - new shares requested plus shares remaining for future grants plus outstanding unvested/unexercised grants; and

    - new shares requested plus shares remaining for future grants.

- *Plan Features (20% weighting)*:

    - automatic single-triggered award vesting upon a change in control;

    - discretionary vesting authority;

    - liberal share recycling on various award types; and

    - minimum vesting period for grants made under the plan.

- *Grant Practices (35% weighting)*:

    - the company's three-year burn rate relative to its industry/market cap peers;

    - vesting requirements in most recent CEO equity grants (three-year lookback);

    - 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;

    - the proportion of the CEO's most recent equity grants/awards subject to performance conditions;

    - whether the company maintains a clawback policy; and

    - whether the company has established post exercise/vesting share-holding requirements.

In its updated voting policy, ISS will generally recommend voting "against" the plan proposal if the combination of the factors listed above in the EPSC Pillars indicates that the plan is not, overall, in the shareholders' interests, or if any of the following apply:

- awards may vest in connection with a liberal change-of-control definition;

- the plan would permit repricing or cash buyout of underwater options without shareholder approval (either by expressly permitting it – for NYSE and Nasdaq listed companies – or by not prohibiting it when the company has a history of prepricing – for non-listed companies);

- the plan is a vehicle for "problematic pay practices" or a "pay-for-performance disconnect;" or

- any other plan features are determined to have a "significant negative impact on shareholder interests."

Political Contributions

Under the updated policy on political contribution shareholder proposals and amended policy regarding disclosure of contributions made to trade associations, ISS will generally recommend that shareholders vote "for" proposals requesting greater disclosure of a company's political contributions and trade association spending policies and activities, after considering:

- the company's policies as well as 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 where it makes political contributions; and

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

Greenhouse Gas Emissions

ISS updated its policy with respect to shareholder proposals seeking the adoption of greenhouse gas ("GHG") reduction goals from company products or operations to provide greater clarity on the factors that are considered in its case-by-case analysis. ISS updated its policy by:

- removing the following factors from its consideration: (i) overly prescriptive requests for the reduction in GHG emissions by specific amounts or within a specific time frame and (ii) the feasibility of reduction of GHGs given the company's product line and current technology (both (i) and (ii) are currently covered under the "ISS Global Approach on Environmental and Social" shareholder resolutions); and

- expanding the current policy to include, as relevant factors of consideration, disclosure of (i) year-over-year GHG emissions performance data, (ii) the company's actual GHG emissions performance, and (iii) the company's current GHG emission policies, oversight mechanisms and related initiatives.

During the 2014 proxy season, there were 21 resolutions submitted that asked companies to adopt goals to reduce their GHG emissions compared to four in 2013 and nine in 2012. However, more than half of the proposals submitted in 2014 were withdrawn by their sponsors and nine resolutions went to a vote.

Glass Lewis 2015 Updates to Proxy Paper Guidelines

Governance Committee Performance

Glass Lewis adopted a policy where, depending on the circumstances, it will recommend that shareholders vote "against" the chairman of the governance committee, or the entire committee, in instances where a board has amended the company's governing documents, without shareholder approval, to "reduce or remove important shareholder rights, or to otherwise impede the ability of shareholders to exercise such right." Examples of board actions cited by Glass Lewis 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 by shareholders to call a special meeting;

- an increase to vote requirements for charter or bylaw amendments;
- the adoption of provisions that limit the ability of shareholders to pursue full legal recourse (e.g., bylaws that require arbitration of shareholder claims or "fee-shifting" bylaws);
- the adoption of a classified board structure; and
- the elimination of the ability of shareholders 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 during whose tenure 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 to respond adequately. According to Glass Lewis, such shareholder proposals include those seeking to declassify the board structure, implementing a majority voting standard for director elections or allowing shareholders to call special meetings. The updated policy specifies that in determining whether a board has sufficiently implemented such a proposal, Glass Lewis will examine the quality of the right enacted, including any conditions that may unreasonably interfere with the shareholders' ability to exercise the right.

Independent Chairman

Glass Lewis amended its 2015 voting policy to state that in situations where a company does not have either an independent chairman or an independent lead director, Glass Lewis will recommend voting "against" the chair of the governance committee. Glass Lewis will continue to generally support the separation of the chairman and CEO roles whenever the question is posed in a proxy. Additionally, the updated 2015 voting policy states that while many companies have an independent lead or presiding director who performs many of the same functions of an independent chairman, Glass Lewis "do[es] not believe this alternate form of independent board leadership provides as robust protection for shareholders as an independent chairman."

"Material" Transactions with Directors

Glass Lewis updated its voting policy with regard to its $120,000 threshold for determining the materiality of a transaction with a director employed by a professional services firm. Glass Lewis may deem such a transaction over the $120,000 threshold to be immaterial if (i) the company pays the firm, not the individual, for services, (ii) the amount represents less than 1% of such firm's annual revenues, and (iii) the board provides a compelling rationale as to why the director's independence is not affected by the relationship.

Director Compensation Bylaws

Glass Lewis updated its voting policy on the "Nominating and Governance Committee Performance" to recommend a vote "against" all members of the governance committee during whose tenure the board adopted, without shareholder approval, "provisions in its charter or bylaws that, through rules on director compensation, may inhibit the ability of shareholders to nominate alternative director candidates."

Proxy Access

While in its 2014 voting guidelines Glass Lewis refrained from establishing parameters with regard to proxy access, the 2015 guidelines state that Glass Lewis considers several factors when evaluating whether to support proxy access proposals, including the specified minimum ownership and holding requirement for shareholders to nominate one or more directors, company size, performance and responsiveness to shareholders.

Exclusive Forum and “Fee-Shifting” Bylaws

The revised Glass Lewis policy regarding exclusive forum provisions adds a requirement that the company must narrowly tailor such provision to the risks involved in order to obtain a recommendation from Glass Lewis in favor of the exclusive forum charter or bylaw provision that is put to a vote.

Glass Lewis amended its 2015 voting guidelines to expressly address “fee-shifting” bylaws. Glass Lewis “strongly opposes” the adoption of such “fee-shifting” bylaws and will recommend voting “against” the governance committee if a “fee-shifting” bylaw is adopted without shareholder approval.

Advisory Vote on Executive Compensation

The 2015 voting guidelines include Glass Lewis’ approach to analyzing one-off awards granted outside of existing incentive programs. Generally, Glass Lewis warns shareholders to be wary of awards granted outside of the standard short-term and long-term incentive schemes. Glass Lewis believes that if an existing incentive program fails to provide adequate incentives to executives, companies should *redesign* their compensation programs rather than make additional grants.

However, in the certain cases where additional incentives may be appropriate, Glass Lewis advises companies to (i) 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, (ii) tie such awards to future service and performance whenever possible, and (iii) describe if and how the regular compensation arrangements will be affected by the 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.

Glass Lewis has also provided clarification regarding its qualitative and quantitative approach to say-on-pay analysis. Qualitative factors such as an effective overall incentive structure, the relevance of selected performance metrics, significant forthcoming enhancements or reasonable long-term payout levels may give Glass Lewis cause to recommend in favor of a proposal even if Glass Lewis has identified a disconnect between pay and performance.

Recoupment Provisions

Glass Lewis provides in the updated guidelines that it believes recoupment or “clawback” policies should be (i) triggered in the event of a restatement of financial results or similar revision of performance indicators upon which bonuses were based and (ii) subject to limited discretion.

Employee Stock Purchase Plans

Glass Lewis added a description of its quantitative model used to analyze employee stock purchase plans (“ESPPs”). The quantitative model estimates the cost of the plan by measuring the expected discount, purchase period, expected purchase activity and whether the plan has a “lookback” feature, and then it compares this cost to ESPPs at similar companies. Glass Lewis will generally support ESPPs given the regulatory purchase limit of $25,000 per employee per year. Glass Lewis also considers the number of shares requested to see if an ESPP will significantly contribute to overall shareholder dilution or if shareholders will not have a chance to approve the program for an excessive period of time.

Conclusion

While the ISS and Glass Lewis guidelines may influence governance trends, public companies should tailor their individual governance policies with a view towards what is in the long-term best interests of their own shareholders. Companies should continue a regular dialogue with key investors, bearing in mind limitations imposed by the Securities and Exchange Commission and stock exchange regulations. Many institutional investors are increasingly bifurcating the portfolio management and proxy voting functions, so efforts to engage those shareholders may entail two separate communication channels. At the end of the day, good governance should not be a function of following any one set of recommended practices or satisfying any individual commentator.

Contacts

Steven M. Haas
shaas@hunton.com

Scott H. Kimpel
skimpel@hunton.com

W. Lake Taylor, Jr.
tlake@hunton.com