Simpson Thacher

Memorandum

ISS and Glass Lewis Issue Updates to Their Proxy Voting Guidelines for 2015 Season

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Institutional Shareholder Services Inc. ("ISS") and Glass Lewis have both released updates to their respective proxy voting guidelines.[1] ISS's revised policies will take effect for annual meetings occurring on or after February 1, 2015. Glass Lewis's new policies will take effect for meetings occurring after January 1, 2015, while its clarifications of existing policies are effective immediately.

I. Updates to ISS's Proxy Voting Guidelines

A. Unilateral Bylaw/Charter Amendments

ISS has adopted a standalone policy for the coming proxy season that it states codifies its current policy application regarding unilateral bylaw/charter amendments. Under the new policy, "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 generally recommend a vote against or withhold from individual directors, committee members, or the entire board (except new nominees, which will be considered on a case-by-case basis). Factors that ISS will consider in its determination include:

- the board's rationale for adopting the amendment without shareholder approval;
- disclosure by the company of any significant engagement with shareholders regarding the amendment;
- the level of impairment of shareholders' rights caused by the unilateral amendment;

[1] *See* Institutional Shareholder Services Inc., Proxy Voting Guideline Updates (Nov. 6, 2014); Glass Lewis & Co., Proxy Paper Guidelines, 2015 Proxy Season.

- the board's track record regarding 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 that may be relevant to determine the impact of the amendment on shareholders.

According to ISS, this policy is intended, in part, to address "a recent trend of companies adopting a suite of shareholder-unfriendly governance provisions shortly before, or on the date of, their initial public offerings" by considering this as a factor when formulating vote recommendations for directors of IPO companies.

B. Shareholders' Litigation Rights

ISS has expanded its previous case-by-case policy on exclusive venue provisions to cover "other types of bylaws which have a material impact on shareholders' litigation rights." With regard to bylaw provisions "impacting shareholders' ability to bring suit against the company" – including exclusive venue, mandatory arbitration and fee-shifting provisions, as well as "potential future variants" – ISS will make its recommendation on a case-by-case basis, taking into account:

- the company's stated rationale for adopting the provision;
- disclosure of past harm from shareholder lawsuits in which plaintiffs were unsuccessful or shareholder lawsuits outside the jurisdiction of incorporation;
- the scope of the bylaw, including the lawsuits to which it would apply and definitions of key terms; and
- governance features such as shareholders' ability to repeal the provision, shareholders' ability to hold directors accountable through annual elections, and a majority vote standard in uncontested elections.

In addition, ISS will generally 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)."

C. Independent Chair Proposals

Under its previous policy, ISS generally recommended voting for shareholder proposals requiring an independent chairman, unless the company counterbalanced the combined chairman/CEO structure through *all* of six enumerated governance features. ISS will now generally recommend voting for independent chair shareholder proposals, taking into consideration:

- the scope of the proposal;
- the company's current board leadership structure;
- the company's governance structure and practices;
- company performance; and
- any other relevant factors that may be applicable.

This updated policy thus adds "new governance, board leadership, and performance factors to the analytical framework," including:

- the absence/presence of an executive chair;
- recent board and executive leadership transitions at the company;
- director/CEO tenure; and
- a longer (five-year) TSR performance period.

Additionally, ISS will "look at all the factors in a holistic manner." Under the revised policy, "any single factor that may have previously resulted in a 'For' or 'Against' recommendation may be mitigated by other positive or negative aspects, respectively."

In 2014, ISS recommended voting against 52% and for 48% of independent chair shareholder proposals among Russell 3000 companies. It is possible that ISS's revised policy will result in more ISS recommendations in favor of proposals seeking to separate the roles of chairman and CEO.

D. Equity-Based and Other Incentive Plans

Under its previous policy, ISS recommended voting case-by-case on equity-based compensation plans, but recommended voting against a plan if any of six enumerated factors applied. ISS's new policy employs a "scorecard" model "that considers a range of positive and negative factors," instead of a series of pass/fail tests, to evaluate equity incentive plan proposals. Under the Equity Plan Scorecard ("EPSC"), ISS will base its recommendation on an evaluation of factors that fit into three main categories, weighted as follows for S&P 500/Russell 3000 companies:

- plan cost (45%) (*i.e.*, the "total estimated cost of the company's equity plans relative to industry/market cap peers, measured by the company's estimated Shareholder Value Transfer (SVT) in relation to peers");
- plan features (20%) (*i.e.*, 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); and
- the company's equity grant practices (35%) (*i.e.* the company's three-year burn rate relative to its

industry/market cap peers; vesting requirements in the most recent CEO equity grants (3-year lookback); 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; proportion of the CEO's most recent equity grants/awards subject to performance conditions; whether the company maintains a claw-back policy; and whether the company has established post exercise/vesting share-holding requirements).

According to ISS, "[w]hile some highly egregious features will continue to result in negative recommendations regardless of other factors (e.g., authority to reprice options without seeking shareholder approval), EPSC recommendations will largely be based on a combination of factors." Accordingly, "a plan where cost is nominally higher than a company's allowable cap may receive a favorable recommendation if sufficient positive factors are present. Conversely, a plan where cost is nominally lower than the allowable cap may ultimately receive a negative recommendation if a preponderance of scorecard factors is negative."[2]

E. Political Contributions

ISS continues to recommend generally voting for "proposals requesting greater disclosure of a company's political contributions and trade association spending policies and activities," taking several factors into account. ISS has fine-tuned its policy, most notably by clarifying that ISS will review and consider "management and board oversight mechanisms" in applying its policy. The factors ISS will consider are:

- the company's policies, as well as management and board oversight related to the company's 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.

F. Greenhouse Gas (GHG) Emissions

ISS continues to recommend voting case-by-case on proposals calling for the adoption of greenhouse gas reduction goals from products and operations, but clarifies the factors it will consider in its analysis. ISS will take into account:

- whether the company provides disclosure of year-over-year GHG emissions performance data;

[2] ISS plans to release a Compensation FAQ next month, which will contain additional information regarding its policy and weightings.

- whether company disclosure lags behind industry peers;
- the company's actual GHG emissions performance;
- the company's current GHG 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 GHG emissions.

II. Notable Updates to Glass Lewis's Proxy Paper Guidelines

A. Governance Committee Performance

Glass Lewis has adopted a new policy under which it "may recommend that shareholders vote against the chairman of the governance committee, or the entire committee" if the board unilaterally amends its governing documents "to reduce or remove important shareholder rights, or to otherwise impede the ability of shareholders to exercise such right." According to Glass Lewis, examples of board actions that could trigger such a recommendation include:

- eliminating shareholders' ability to call a special meeting or act by written consent;
- increasing the ownership threshold required for shareholders to call a special meeting;
- increasing vote requirements for charter or bylaw amendments;
- adopting provisions limiting shareholders' ability "to pursue full legal recourse" (*e.g.*, mandatory arbitration bylaws, fee-shifting bylaws);
- adopting a classified board structure; and
- eliminating the ability of shareholders to remove a director without cause.

B. 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." Examples of such shareholder proposals include those seeking:

- a declassified board structure;
- a majority vote standard for director elections; or
- the right to call a special meeting.

In its updated policy, Glass Lewis specifies that in determining whether a board has sufficiently implemented the proposal, it will "examine the quality of the right enacted or proffered by the board 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).”

C. Vote Recommendations Following Initial Public Offering (“IPO”)

According to Glass Lewis, while it “will generally refrain from issuing voting recommendations on the basis of most corporate governance best practices (e.g., board independence, committee membership and structure, meeting attendance, etc.) during the one-year period following an IPO,” it has increased its scrutiny of certain bylaw/charter provisions adopted prior to the company’s IPO. If the provisions are not put to shareholder vote following the IPO, Glass Lewis will consider recommending that shareholders vote against:

- all members of the board who served at the time of the adoption of an anti-takeover provision (*e.g.*, a poison pill, classified board);
- the governance committee chair, in the event an exclusive forum provision is adopted; or
- the entire governance committee if the board adopts “a provision limiting the ability of shareholders to pursue full legal recourse” (*e.g.*, fee-shifting bylaws).

D. Standards for Assessing “Material” Transactions with Directors

In defining a “material” relationship for the purposes of determining director independence, Glass Lewis’s previous policy set a $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.” In its updated policy, Glass Lewis clarifies that a transaction that exceeds the $120,000 threshold may nonetheless be deemed immaterial “where the amount represents less than 1% 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.”

E. Advisory Vote on Executive Compensation (“Say-on-Pay”)

Glass Lewis has added to its “say-on-pay” analysis a new element regarding the consideration of “one-off awards granted outside of existing incentive programs.” In its updated policy, Glass Lewis indicates that “shareholders should generally be wary of awards granted outside of the standard incentive schemes . . . as such awards have the potential to undermine the integrity of a company’s regular incentive plans, the link between pay and performance or both.” According to Glass Lewis, “if the existing incentive programs fail to provide adequate incentives to executives,” it is generally preferable for a company to redesign its compensation programs instead of making additional grants. Glass Lewis recognizes, however, that there are circumstances in which additional incentives may be appropriate. Glass Lewis provides that in those cases:

- companies should provide a thorough description of the awards and their necessity;

- such awards should be tied to future service and performance, where possible; and
- companies should describe if and how the supplemental awards will affect regular compensation arrangements.

In reviewing a company's use of supplemental awards, Glass Lewis will consider "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."

F. Employee Stock Purchase Plans ("ESPPs")

Glass Lewis's updated guidelines include a new discussion regarding the firm's approach to analyzing ESPPs. In analyzing ESPPs, Glass Lewis will use 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.

Glass Lewis will then compare this cost to ESPPs at similar companies.

Glass Lewis notes that "[e]xcept for the most extreme cases," it will generally support ESPPs "given the regulatory purchase limit of $25,000 per employee per year." Glass Lewis will also consider 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." Accordingly, Glass Lewis will generally recommend against "ESPPs that contain 'evergreen' provisions that automatically increase the number of shares available under the ESPP each year."

If you have any questions or would like additional information, please do not hesitate to contact **Yafit Cohn** at (212) 455-3815 or yafit.cohn@stblaw.com, or any other member of the Firm's Public Company Advisory Practice

Simpson Thacher Worldwide

UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1 212-455-2000

Houston
2 Houston Center
909 Fannin Street
Houston, TX 77010
+1 713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1 310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1 650-251-5000

Washington, D.C.
1155 F Street, N.W.
Washington, D.C. 20004
+1 202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44 (0)20-7275-6500

ASIA

Beijing
3919 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86 10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852 2514-7600

Seoul
West Tower, Mirae Asset Center 1
26 Eulji-ro 5-gil, Jung-gu
Seoul 100-210
Korea
+82 2-6030-3800

Tokyo
Ark Hills Sengokuyama Mori
Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81 3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55 11-3546-1000