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Memorandum

ISS Issues Draft Voting Policies for 2015

October 22, 2014

On October 15, 2014, Institutional Shareholder Services Inc. ("ISS") issued draft voting policies for the 2015 proxy season.[1] ISS proposed changes to two policies affecting U.S. companies – its equity plans policy and its policy on independent chair proposals.

ISS is requesting feedback from all interested parties on its draft policies and will accept comments through October 29 at 6:00 p.m. (Eastern time). ISS plans to release its final 2015 policies on or around November 7. These policies will take effect for shareholder meetings held on or after February 1, 2015.

Equity Plan Proposals

ISS's current policy on equity plans includes a series of standalone "pass/fail" tests, any one of which could determine that a proposal warrants an "against" recommendation. For example, under its current policy, ISS recommends voting against an equity plan if:

- its cost is "unreasonable";
- it "expressly permit[s] the repricing or exchange of underwater stock options/stock appreciate rights (SARs) without prior shareholder approval";
- the CEO is one of the plan's participants and "a significant portion of the CEO's misaligned pay is attributed to non-performance-based equity awards";
- the company's three-year burn rate exceeds the burn rate cap (as calculated pursuant to ISS policy);
- "the plan has a liberal definition of change in control (it provides for the acceleration of vesting of equity awards even though an actual change in control may not occur) and the equity awards would

[1] *See* ISS, 2015 Benchmark Policy Consultation, available at http://www.issgovernance.com/policy-gateway/2015-benchmark-policy-consultation/.

automatically vest upon such liberal definition of change-in-control"; or

- the equity plan is "a vehicle for problematic pay practices."[2]

ISS proposes replacing its "pass/fail" tests with a "scorecard" model, which is "more nuanced" and "takes into account multiple factors, both positive and negative, related to plan features and historical grant practices."[3] Under ISS's proposed Equity Plan Scorecard ("EPSC"), ISS will base its recommendation on an evaluation of factors that fit into three main categories:

- **plan cost** (*i.e.*, the "total potential 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** (*e.g.*, 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** (*e.g.*, the company's three-year burn rate relative to its industry/market cap peers; vesting requirements in most recent CEO equity grants; 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).

Under ISS's proposed policy, the EPSC factors and weightings "will be keyed to company size and status: S&P 500, Russell 3000 (excludes S&P 500), Non-Russell 3000, and Recent IPOs or Bankruptcy Emergent companies."

Expounding on its proposed "scorecard" model, ISS explains that "[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)," the 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."

According to ISS, its proposed policy "is not designed to increase or decrease the number of companies that would receive adverse vote recommendations." Nonetheless, ISS's proposed policy may accelerate the trend away from practices that ISS characterizes as poor pay practices.

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[2] ISS, 2014 U.S. Proxy Voting Summary Guidelines, at 42-45 (Mar. 12, 2014).
[3] ISS, Equity Plan Scorecard (U.S.) [proposed].

ISS requests feedback on its proposed policy change, particularly in response to the following questions:

- Are there certain factors outlined in the proposed scorecard approach that should be more heavily weighted when evaluating equity plan proposals?
- Do you see any unintended consequences from shifting to a scorecard approach?

Independent Chair Shareholder Proposals

Under its current policy, ISS generally recommends voting for shareholder proposals requiring an independent chairman, unless the company counterbalances the combined chairman/CEO structure through all of the following:

- designating a lead director, who is elected by and from the independent board members with clearly delineated and comprehensive duties;
- having a board that is at least two-thirds independent;
- having key board committees that are fully independent;
- having established governance guidelines;
- for Russell 3000 companies, not exhibiting sustained poor total shareholder return (TSR) performance ("defined as one- and three-year TSR in the bottom half of the company's four digit industry group, unless there has been a change in the CEO position within that time")[4]; and
- not having "any problematic governance or management issues" (such as egregious compensation practices, multiple related-party transactions or other issues putting director independence at risk, corporate or management scandals, excessive problematic corporate governance provisions, or flagrant actions by management or the board with potential or realized negative impacts on shareholders).[5]

ISS proposes to update its policy "by adding 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.[6]

[4] ISS, Independent Chair Shareholder Proposals (U.S.) [proposed].
[5] ISS, 2014 U.S. Proxy Voting Summary Guidelines, at 20.
[6] ISS, Independent Chair Shareholder Proposals (U.S.) [proposed].

In addition, ISS's proposes "to look at all of the factors in a holistic manner." Under this new flexible approach, "any single factor that may have previously resulted in a 'For' or 'Against' recommendation may be mitigated by other positive or negative aspects, respectively."

ISS requests comment on its proposed revisions. Specifically, ISS seeks responses to the following questions:

- What factors does your organization consider most important when determining whether an independent chair proposal warrants support?
- How much weight does your organization give to recent changes in board leadership structure (e.g., a switch from an independent chair to a non-independent chair; a recombination of the CEO/chair roles)?
- What time frame should ISS use when assessing financial performance when evaluating independent chair proposals?

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.

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