Skadden

Securities Regulation and Compliance Alert

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If you have any questions regarding the matters discussed in this alert, please contact the following attorneys or your regular Skadden contact.

Brian V. Breheny
202.371.7180
brian.breheny@skadden.com

Marc S. Gerber
202.371.7233
marc.gerber@skadden.com

Richard J. Grossman
212.735.2116
richard.grossman@skadden.com

Neil M. Leff
212.735.3269
neil.leff@skadden.com

Regina Olshan
212.735.3963
regina.olshan@skadden.com

Erica Schohn
212.735.2823
erica.schohn@skadden.com

Joseph M. Yaffe
650.470.4650
joseph.yaffe@skadden.com

Four Times Square, New York, NY 10036
Telephone: 212.735.3000

ISS Releases 2015 Proxy Voting Policy Updates

On November 6, 2014, Institutional Shareholder Services (ISS) released updates to its proxy voting policies, effective for shareholder meetings taking place on or after February 1, 2015. The changes to ISS' U.S. voting policies on corporate governance and executive compensation matters relate to:

- Unilateral board adoption of amendments to charters and bylaws in ways that materially diminish shareholder rights;
- Bylaw provisions limiting shareholder litigation rights (*i.e.*, exclusive venue and fee-shifting bylaws);
- Independent chair shareholder proposals; and
- Equity compensation plans.

ISS also updated and refined its existing policies with respect to shareholder proposals seeking (1) greater disclosure of political contributions and trade association spending and (2) adoption of greenhouse gas reduction goals. Only the policy updates on equity compensation proposals and independent chair proposals were presented in the proposed updates issued by ISS on October 15, 2014.

Board adoption of certain charter/bylaw amendments. Beginning in 2015, ISS will follow a policy — purportedly a codification of existing policy — for evaluating incumbent director nominees following amendments of the company's charter or bylaws without shareholder approval. ISS will recommend voting against or withholding from directors where ISS views such amendments as materially diminishing the rights of shareholders or otherwise adversely impacting shareholders. Factors ISS will consider when applying this policy are:

- The board's rationale for adopting the 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 amendment;
- The board's track record with regard to unilateral board action on charter/bylaw amendments or other entrenchment provisions;
- The company's ownership structure and existing governance provisions;
- Whether the amendment was made prior to or in connection with the company's IPO;

- The timing of the amendment in relation to a significant business development; and
- Other factors, as ISS deems appropriate, to determine the impact of the amendment on shareholders.

ISS reported that it adopted this change to its voting policies in response to concerns raised by investors in ISS' recent policy survey. Of the investors that responded to that survey, 72 percent indicated that a board of directors "should never adopt amendments that negatively impact investors' rights without shareholder approval" and an additional 20 percent of those investors "indicated a case-by-case approach, depending on the type of bylaw/charter amendment" should be employed to evaluate whether to vote against directors that made these significant changes without shareholder approval.

Limitations on shareholder litigation rights. ISS has expanded its policy to respond to bylaw provisions impacting shareholders' ability to bring lawsuits against companies. These provisions include exclusive venue provisions, which typically provide that a single state will be the sole venue for certain types of shareholder litigation, and fee-shifting provisions, which require a shareholder who sues the company unsuccessfully to pay the company's litigation expenses. Beginning in 2015, ISS will recommend votes on a case-by-case basis on bylaws that impact shareholders' litigation rights, taking into account factors such as:

- The company's stated rationale for adopting such 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 and to hold directors accountable through annual director elections and a majority vote standard in uncontested elections.

ISS will recommend voting against bylaws that mandate fee-shifting when plaintiffs are not completely successful on the merits.

Significantly, ISS states that unilateral board adoption of these provisions will be evaluated under ISS's new policy on board adoption of amendments that materially limit shareholder rights (*see above*).

Shareholder proposals requiring an independent chair. Beginning in 2015, ISS will recommend generally voting for shareholder proposals requiring that the chairman's position be filled by an independent director, taking into consideration:

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

In particular, ISS will support proposals, absent a compelling rationale, where there is an executive or non-independent chair in addition to the CEO, or the chair and CEO roles have recently been recombined.

ISS cited the increased number of shareholder proposals calling for independent board chairs — more than doubling over the past five years — as a key reason for this policy change. The decision by some companies to revert to a combined CEO/chair structure was also cited as rationale for the change.

Equity Plan Scorecard. ISS has significantly restructured its approach to considering voting recommendation on equity compensation plan proposals. For companies intending to present new, restated or amended equity compensation plans to shareholders for approval in the coming proxy season, an understanding of this new system will be critical in order to maximize the chances of a "for" recommendation from ISS.

Under the current approach, an "against" recommendation can be triggered by failure of one of a series of pass/fail tests: whether the cost of the company's equity plans, taking into account the new plan, is reasonable, based on a proprietary ISS measurement of shareholder value transfer (SVT); whether the three-year burn rate exceeds an ISS-determined cap; whether the company has a pay-for-performance misalignment; and whether the plan contains certain problematic features (*e.g.*, permitting repricing).

The new policy (which ISS has named the Equity Plan Scorecard, or EPSC) represents a shift to a more holistic analysis based on the following factors, which will be weighted as follows for companies in the S&P 500 and Russell 3000:

- **Plan Cost (45%)** – measures SVT relative to peers (determined based on industry and market capitalization), calculated in two ways: first, only new shares requested plus shares remaining for future grants; and second, new shares requested plus shares remaining for future grants, *plus* outstanding unvested/unexercised grants.
- **Plan Features (20%)** – evaluates the following plan features: single trigger vesting on a change in control; discretionary vesting authority; liberal share recycling (*e.g.*, returning to the plan shares withheld on vesting to cover taxes); and minimum vesting periods for grants made under the plan.
- **Grant Practices (35%)** – focuses on three-year burn rate relative to peers; vesting requirements in the most recent Chief Executive Officer equity grants (based on a three-year lookback); estimated duration of the plan; proportion of the CEO's most recent equity grants subject to performance conditions; whether the company has a clawback policy; and whether the company has established post-exercise/vesting holding periods for the shares received.

Some key points to note are as follows:

- Unlike the current series of pass/fail tests, under the EPSC approach a low score in one area can be offset by a high score in another. As such, a plan with a cost that is somewhat higher than that of peers could potentially still receive a "For" recommendation if plan feature and grant practice considerations are extremely positive. Conversely, a lower plan cost may not be sufficient to receive a "For" recommendation if the plan includes enough problematic provisions or if past grant practices raise concerns.
- Many of the grant practice measures are historical in nature, which may be problematic for companies introducing new equity plans for the very purpose of improving their compliance with current governance standards. It is unclear what weighting these historical practices will be given within the "Grant Practices" analysis.
- For a company with no clawback or share holding period requirements, the adoption of such policies could be a relatively straightforward way to boost the EPSC score.
- ISS currently sells a service through its consulting arm under which it provides assistance in determining whether the SVT-based cost of a proposed plan is acceptable. It is widely anticipated that ISS will introduce consulting service offerings relating to the proposed EPSC system.

Additional details regarding the Equity Plan Scorecard will be included in the ISS Frequently Asked Questions update, which is expected to be published in December.

Shareholder proposals relating to disclosure of political contributions. ISS has refined its policy on proposals requesting greater disclosure of a company's political contributions and trade association spending policies and activities. ISS will continue to recommend for these proposals, 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 update specifies the types of oversight mechanisms that ISS reviews and updates the policy to reflect the recent evolution of corporate disclosure practices on political contributions.

Shareholder proposals relating to greenhouse gas emissions. ISS has refined its policy on proposals calling for the adoption of greenhouse gas (GHG) reduction goals from products and operations. ISS will continue to review these proposals on a case-by-case basis, taking into account:

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

The update clarifies the factors considered in ISS' analysis and responds to feedback from institutional investors and issuers on the use of quantitative performance goals under the "ISS Global Approach on Environmental and Social" shareholder resolutions.

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A copy of the ISS U.S. policy updates is available here.

Glass Lewis also recently issued an overview of its voting guidelines for the 2015 proxy season. A copy of the overview is available here.