November 11, 2014

ISS and Glass Lewis Issue 2015 Proxy Voting Policies

ISS and Glass Lewis have released their voting policy updates for the upcoming proxy season. Of particular note is that both add policies disfavoring the unilateral adoption by boards of bylaw and charter amendments that affect shareholder rights (including the ability to call special meetings and fee-shifting and mandatory arbitration requirements). Besides the foregoing, ISS included updates to its policies on independent chair, equity incentive plan, political contribution and greenhouse gas proposals, and Glass Lewis included updates to its policies on board responsiveness to majority-approved shareholder proposals, director independence and the evaluation of executive compensation and employee stock purchase plans. Both firms also issued policies for non-U.S. jurisdictions in addition to the U.S. voting policies highlighted below. For the ISS policy updates, see http://www.issgovernance.com/policy-gateway/2015-policy-information/. For the Glass Lewis updates, see http://www.glasslewis.com/resource/guidelines/

ISS Policy Updates

Unilaterally Adopted Bylaw/Charter Amendments

ISS adds a new, standalone policy generally to recommend a vote against or withhold from one or more directors (except for new nominees who will be considered on a case-by-case basis) if the board unilaterally adopts (without shareholder approval) bylaw or charter amendments that materially diminish shareholder rights or could adversely affect shareholders. ISS states that this is a codification of its current approach to unilateral bylaw/charter amendments, which had previously been evaluated as part of ISS's determination of whether the board exhibited "governance failures". Under the new policy, ISS will weigh factors that it deems appropriate and relevant to determine the amendment's impact on shareholders, but lists several specific factors related to the board's rationale for adopting the provision without shareholder approval, the timing of the changes (whether it relates to a significant business development or was adopted in the context of the company's initial public offering), the company's ownership and governance structure and the company's disclosure regarding shareholder engagement on the amendment.

ISS does not explicitly identify which types of provisions this policy will cover, but its 2015 policy survey (and past recommendation history) suggest that the following may raise issues (in order from most problematic to least): provisions that diminish shareholder rights to call a special meeting or act by written consent; fee-shifting provisions; increases in advance notice requirements and exclusive forum provisions. Other provisions may in fact be more problematic (such as board classification and increasing authorized capital or voting or quorum requirements); however, those provisions require a charter amendment under Delaware law and therefore would be subject to shareholder approval. In this regard, it is unclear how ISS will address pre-IPO adopted provisions that are not subsequently approved by the public shareholders.

Shareholder Litigation Rights

ISS is broadening its existing policy on exclusive forum provisions to cover bylaws that adversely affect shareholder litigation rights. Under this new expanded policy, ISS will generally recommend against bylaws that mandate fee-shifting if plaintiffs are not completely successful on the merits (i.e., bylaws that require fee-shifting even if plaintiffs are partially successful). ISS will consider other bylaws that adversely affect shareholders' litigation rights (such as exclusive forum, mandatory arbitration or perhaps other variations of fee-shifting bylaws) on a case-by-case basis, taking into account specified factors that include the company's rationale for the provision, its disclosure of past harm from shareholder lawsuits outside the company's jurisdiction of incorporation or where plaintiffs were unsuccessful and the key terms of the bylaw and other corporate governance features of the company (such as whether the shareholders can repeal the bylaw and whether there are annual director elections subject to a majority vote standard.)

While the validity of exclusive forum bylaws is increasingly well-established in Delaware (see, e.g., *City of Providence v. First Citizens BancShares, Inc.* and *Boilermakers Local 154 Retirement Fund v. Chevron Corporation and IClub Investment Partnership v. FedEx Corporation*), other board-adopted bylaws remain controversial. For example, fee-shifting bylaws, which were upheld as facially valid in *ATP Tour, Inc. v. Deutscher Tennis Bund* earlier this year, have been the subject of great debate. Former Justice Jack Jacobs, who was on the court that decided *ATP Tour*, stated at a Practicing Law Institute panel last Friday that the decision is "very limited" and that the court only meant to address the provision in the private "club" context in which the case arose. Further, the Delaware legislature is likely to restrict fee-shifting provisions when it takes up the issue in 2015, although it remains to be seen whether the legislature will adopt a strict prohibition of such provisions or a clarification that they will be permitted only in narrowly defined circumstances and/or with periodic reaffirmation by shareholders.

Independent Chair; Separate Chair/CEO

ISS is updating its existing policy generally to vote for shareholder proposals requiring an independent board chair by adding new factors, and by weighing negative factors against positive ones in a "holistic manner" (as compared to its current checklist approach). In making its recommendation, ISS may consider any relevant factors, including certain specified factors related to the scope of the proposal, the company's current board leadership structure (e.g., ISS may support the proposal, absent a compelling rationale, if the company has an non-independent chair in addition to the CEO or recently recombined the role of CEO and chair), the company's governance structure and practices and company performance as measured by the company's one, three and five-year TSR compared to its peers and the market as a whole. ISS anticipates this new policy will result in an increase in its support of independent chair proposals, which may have a significant impact on the approval rates of these proposals.

Equity Compensation Plans

ISS is adopting a new "scorecard" system to evaluate equity plan proposals. Under the updated policy, ISS will make recommendations on a case-by-case basis depending on a combination of factors as evaluated under the three "pillars" of plan cost, plan features and grant practices, which will be weighed for S&P 500 and Russell 3000 companies 45%, 20% and 35%, respectively. Among other things, this updated policy will:

- Use three index groups (S&P 500, Russell 3000 and non-Russell 3000) to determine burn-rate benchmarks and factor weightings, with a different version of the scorecard system being developed for companies that recently went public or emerged from bankruptcy where the burn-rate factor does not apply and also use individual scorecards for each index group and recent IPO companies;

- Measure plan cost by the company's estimated Shareholder Value Transfer ("SVT") by both the company's total new and previously reserved equity plan shares plus outstanding grants and awards ("A+B+C shares") and only the new request plus previously reserved but ungranted shares ("A+B shares");

- Eliminate option overhang carve-outs, given the additional SVT evaluation factor for only A+B shares; and

- Eliminate consideration of "liberal share recycling" provisions from the SVT cost calculations; instead, scoring share recycling as a negative plan feature.

ISS will generally vote against a plan proposal if a weighing of the three pillars indicates that the plan is not in shareholders' interests, or if the plan furthers problematic pay practices (such as vesting with a liberal change-in-control definition or option repricing or buyout without shareholder approval) or is a vehicle for a pay-for-performance disconnect. Additional information about this policy, including weighting for non-S&P 500 and non-Russell 3000 companies, will be published in ISS's executive compensation FAQ due out in December.

Environmental and Social Issues

ISS is updating its policy generally to vote for proposals requesting greater political contributions disclosure to clarify that it will take into consideration board and management oversight of a company's direct political contributions and payments to trade associations and other political groups, as well as the company's disclosure regarding its support of and participation in trade associations or other groups that make political contributions. ISS is also updating its policy to consider on a case-by-case basis proposals that call for the reduction of greenhouse gas emissions from the company's products and operations, to eliminate as factors the possibility of overly prescriptive requests and the feasibility of greenhouse gas reductions and to add other factors for consideration, including whether the company discloses year-over-year greenhouse gas emissions performance data, the company's actual greenhouse gas emissions performance and whether the company has been the subject of recent, significant violations, fines, litigation or controversy related to greenhouse gas emissions.

Glass Lewis Policy Updates

Unilateral Adoption of Bylaw/Charter Amendments that Reduce, Remove or Impede the Exercise of Important Shareholder Rights

Similar to ISS, Glass Lewis is amending its policy on governance committee performance also to address situations where a board has amended the company's governing documents to reduce, remove or impede the exercise of "important" shareholder rights without shareholder approval, in which case, Glass Lewis may recommend a vote against the governance committee or its chair. Actions that may incur a negative recommendation include eliminating the right of, or increasing the threshold required for, shareholders to call a special meeting; eliminating the ability of shareholders to act by written consent; adding supermajority vote requirements; limiting the ability of shareholders to pursue full legal recourse (such as mandatory arbitration or fee-shifting bylaws); classifying a board and eliminating the ability of shareholders to remove a director without cause. Unlike ISS, Glass Lewis does not appear to distinguish between different variants of fee-shifting provisions. We note that Glass Lewis already has an existing policy to recommend against the governance committee chair if an exclusive forum provision is adopted without shareholder approval or if such approval is sought, but as part of a bundled bylaw amendment, rather than as a separate proposal.

With respect to recent IPO companies, Glass Lewis adds a policy to recommend a vote against the entire governance committee if a board adopts, without post-IPO shareholder approval, any provision that limits the ability of shareholders to pursue full legal recourse (e.g., fee-shifting bylaws).

Board Responsiveness to Majority-Approved Shareholder Proposals

Glass Lewis clarifies that in determining the sufficiency of a board's response to a majority approved shareholder proposal that relates to important shareholder rights (such as board declassification, majority vote or special meeting proposals) in the context of recommending a vote for or against the governance committee, it will examine the quality of any rights enacted or offered by the board for any conditions that may unreasonably interfere with the shareholders' exercise of that right (such as overly prescriptive procedural requirements for calling a special meeting).

Director Independence Standards

Glass Lewis clarifies that payments of more than $120,000 to a professional services firm that employs a director may be deemed immaterial if the amount paid is 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.

Say-on-Pay and Other Executive Compensation Matters

Glass Lewis adds a discussion of its approach to one-off awards granted outside of existing incentive programs, warning shareholders that such awards may undermine the integrity of existing programs and break the link between pay and performance. If existing programs do not incentivize executives adequately, Glass Lewis believes that companies should redesign them rather than make separate grants. If the company deems such grants appropriate, however, Glass Lewis will examine the adequacy of the disclosure surrounding such grants, including a thorough description of the awards, a "cogent and convincing explanation" of the need for the awards and why existing awards are insufficient and if and how existing compensation arrangements will be affected. Further, Glass Lewis will review the terms and size of the grants in the context of the company's overall incentive strategy and grant practices and the current operating environment and recommends that such awards be tied to future service and performance whenever possible. Glass Lewis also generally clarifies its quantitative and qualitative approach to say-on-pay review by, among other things, noting that it considers the challenging nature of the performance metrics used in setting executive compensation and also will consider all problematic contractual payments (as opposed to just guaranteed bonuses) in its determination.

Employee Stock Purchase Plans

Glass Lewis adds a discussion of its approach to analyzing employee stock purchase plans. A quantitative model will be used to estimate the plan cost by measuring the expected discount, purchase period, expected purchase activity (if previous activity has been disclosed) and whether the plan has a "look back" feature. Glass Lewis then compares this cost to employee stock purchase plans at similar companies. Except for the most extreme cases, Glass Lewis will generally support these plans given the regulatory purchase limit of $25,000 per employee. Glass Lewis also reviews the number of shares requested to see if the plan will significantly contribute to overall shareholder dilution or if shareholders will not have a chance to approve the plan for an excessive period of time and will generally recommend against purchase plans with evergreen provisions that automatically increase the number of shares available under the plan each year.

*   *   *

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Ariel J. Deckelbaum
212-373-3546
ajdeckelbaum@paulweiss.com

Justin G. Hamill
212-373-3189
jhamill@paulweiss.com

Stephen P. Lamb
302-655-4411
slamb@paulweiss.com

Lawrence I. Witdorchic
212-373-3237
lwitdorchic@paulweiss.com

Reuven Falik
212-373-3399
rfalik@paulweiss.com

Frances F. Mi
212-373-3185
fmi@paulweiss.com