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Proxy Advisory Firms Update Proxy Voting Guidelines

Both Institutional Shareholder Services Inc. (ISS) and Glass Lewis recently released updates to their proxy voting guidelines for the 2015 proxy season. Overall, the updates do not provide for significant changes but continue the trend towards a more shareholder-centric model of corporate governance. Key areas of focus include bylaw amendments, board leadership structures, executive compensation and equity plans.

Notably, both sets of updates adopt a more stringent approach towards boards' adoption of bylaw (and, where applicable, charter) amendments that impact shareholder rights without shareholder approval. Both proxy advisors warn that they may use the significant power of their withhold recommendations in response to a unilateral bylaw amendment "that materially diminishes shareholders' rights or that could adversely impact shareholders" (the ISS formulation) or that "reduce[s] or remove[s] important shareholder rights" (the Glass Lewis formulation). The increased scrutiny of unilateral bylaw amendments will apply not only to provisions like "fee-shifting" bylaws (which require shareholder plaintiffs to pay the company's legal expenses if they fail to obtain a favorable court judgment and which we have [previously discussed](#)), but also appear to apply to changes like [exclusive forum bylaws](#), which limit wasteful and frivolous multi-forum litigation, and [bylaws](#) designed to discourage director conflicts of interest resulting from differential compensation for dissident directors. When updating bylaws, companies should consider explaining the board's rationale for the updates via appropriate disclosure in order to ensure that proxy advisory firms and shareholders understand why particular changes are deemed appropriate and to facilitate discussion with investors.

Board leadership was also addressed in the policy revisions. ISS will implement a more "holistic" methodology in evaluating independent chair proposals, taking into account a number of governance, board leadership and performance factors. Glass Lewis will continue to recommend in favor of independent chair proposals and will now also recommend withhold votes for the governance committee chair of a company with neither an independent chair nor an independent lead director.

Both proxy advisors also revised the methodologies for evaluating compensation-related proposals. ISS created a new "Equity Plan Score Card" (EPSC) as an alternative to its prior series of standalone tests focused on costs and certain egregious pay practices. Under the EPSC regime, recommendations on equity plan proposals will be based on a combination of weighted factors related to plan cost, plan features and company grant practices, with relative weights varying by index group. ISS will continue to recommend a vote against an equity plan if it includes certain problematic features. Glass Lewis' new guidance disfavors out-of-plan equity grants, supports clawbacks and emphasizes the importance of shareholder engagement for companies that receive less than 75% support for their say-on-pay proposals.

The changes to ISS policies are summarized in [Annex A](#), and the changes to Glass Lewis policies are summarized in [Annex B](#). As companies begin to prepare for the 2015 proxy season, they should be mindful of the revised guidelines and anticipate the likely voting recommendations of ISS and Glass Lewis. Companies that will be submitting new or amended incentive plans for shareholder approval should familiarize themselves with the new standards, review the relevant factors when preparing their plans and the related disclosure and consider [verifying the underlying data](#) used in ISS' equity plan "shareholder value transfer" models. However, we continue to believe that when it comes to governance and compensation decisions, one size does not fit all, and boards of directors, as well as fiduciaries with voting responsibilities, should not merely defer to the views of proxy advisory firms but must, as always, carefully consider the long-term best interests of the constituencies they serve.

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## 2015 ISS Proxy Voting Policies

### “Unilateral” Bylaw/Charter Amendments

- Existing approach: ISS will recommend withhold votes against directors in “extraordinary circumstances” involving “material failures of governance, stewardship, risk oversight or fiduciary responsibilities” and will assess bylaw (or, where applicable, charter) amendments adopted “unilaterally” (*i.e.*, without shareholder approval) on a case-by-case basis within that framework.
- New guidelines: ISS will generally recommend withhold votes from individual directors, 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.” In deciding whether to recommend a withhold vote, ISS will consider a number of factors, including the board’s rationale for adopting the amendment without shareholder ratification, disclosure by the company of shareholder engagement regarding the amendment and the level of impairment of shareholders’ rights, among others. While ISS did not include specific details on what kind of amendments would be problematic, ISS has previously provided illustrative examples of actions that would trigger ISS scrutiny if done without a shareholder vote, including increasing the percentage of shares required to call a special meeting, diminishing shareholder rights to call a special meeting or act by written consent, classifying the board, increasing authorized capital, lowering quorum requirements, and adopting director qualification bylaws tied to third-party compensation arrangements.

### Exclusive Forum Provisions and Other Measures Affecting Litigation Rights

- Existing approach: ISS will make case-by-case recommendations on shareholder- or management-sponsored proposals concerning exclusive forum bylaws. ISS guidelines do not address other litigation-related bylaw amendments.
- New guidelines: ISS will make recommendations on a case-by-case basis on proposals seeking shareholder approval of bylaw or charter provisions impacting shareholders’ litigation rights, taking into account various factors such as the company’s stated rationale, disclosure of past harm from shareholder lawsuits in which the plaintiffs were not completely successful outside the jurisdiction of incorporation, the breadth of application of the provisions and other governance features (*e.g.*, shareholders’ ability to repeal the provision at a later date). When any bylaws affecting shareholder litigation rights are adopted “unilaterally,” ISS will also assess withhold recommendations within the context of its new policy on unilateral bylaw amendments described above. ISS will generally recommend voting against shareholder- or management-sponsored proposals seeking approval of fee-shifting bylaws that mandate fee shifting even when plaintiffs are partially successful.

### Board Leadership Structures

- Existing approach: ISS historically has supported independent chair shareholder proposals, even if a robust lead director position is present, if ISS had governance or performance concerns.
- New guidelines: In affirming its policy to generally recommend in favor of separation of the CEO and chair roles and appointment of an independent chair, ISS says it will consider this issue in a more “holistic” context that takes into account whether the proposal is seeking an immediate change or can be implemented at the next CEO transition, the absence or presence of an executive or non-independent chair plus the CEO, recent board and executive leadership transitions, overall governance profile (including director and CEO tenure and prior actions that harmed shareholders) and performance against peers and the market over one-, three- and five-year TSR periods. (ISS’ backtesting indicates this new policy would have resulted in greater ISS support for independent chair proposals than the prior policy.)

### Shareholder Proposals Regarding Equity-Based and Other Incentive Plans

- Existing approach: ISS will vote against an equity plan if any of the following applies: (1) the total cost of the company's equity plans is unreasonable; (2) the plan expressly permits repricing; (3) ISS finds a pay-for-performance misalignment; (4) the company's three-year burn rate exceeds the burn rate cap of its industry group; or (5) the plan is a vehicle for problematic pay practices.
- New guidelines: ISS will continue to recommend against an equity plan if it contains or promotes any of the following: (1) vesting based on a liberal change-in-control definition; (2) repricing without shareholder approval; (3) problematic pay practices or a pay-for-performance disconnect; or (4) any other features that would have a significant negative impact on shareholder interests. However, under a new "Equity Plan Score Card" (EPSC), ISS now will use individual scorecards for each index group (S&P 500, Russell 3000, Non-Russell 3000 and IPO companies) to analyze equity plan proposals. The EPSC approach will weigh factors relating to three key categories (weighting the various factors for S&P 500 and Russell 3000 companies as described below):
  - *Plan Cost (45% weighting):* the total potential cost of the company's equity plans, measured by the company's estimated Shareholder Value Transfer (SVT), relative to its industry/market cap peers, with SVT calculated for both (1) new shares requested, plus shares remaining for future grants, plus outstanding unvested/unexercised grants, and (2) new shares requested, plus shares remaining for future grants.
  - *Plan Features (20% weighting):* (1) automatic, single-triggered award vesting upon a change-in-control; (2) discretionary vesting authority; (3) liberal share recycling on various award types; and (4) minimum vesting period for grants made under the plan.
  - *Grant Practices (35% weighting):* (1) three-year burn rate relative to peers; (2) vesting requirements in most recent CEO equity grants; (3) the estimated duration of the plan; (4) the proportion of the CEO's most recent equity grants/awards subject to performance conditions; and (5) whether the company maintains clawback and shareholding requirements.

The weighting percentages for non-Russell 3000 companies and IPO companies have not been provided, but ISS has advised that additional guidance on the EPSC factors (which presumably will include these weighting percentages) will be released in December under a Compensation FAQ.

### Shareholder Proposals Regarding Political Contributions

- Existing approach: ISS will generally vote for proposals seeking greater disclosure of a company's political contributions and trade association spending policies and activities, considering a number of factors.
- New guidelines: While ISS will continue to generally vote for proposals requesting greater disclosure of a company's political contributions and trade association spending policies and activities, ISS modified the factors that it will consider, including to specify its review of board-level, as well as management-level, oversight mechanisms concerning political contributions and of disclosed trade association support and participation. Specifically, under the revised guidelines, ISS will take into account: (1) the company's policies, and management and board oversight related to direct political contributions and payments to trade associations or other groups that may be used for political purposes; (2) the company's disclosure regarding its support of, and participation in, trade associations or other groups that may make political contributions; and (3) recent significant controversies, fines or litigation related to the company's political contributions or political activities.

Shareholder Proposals Regarding Greenhouse Gas Emissions

- Existing approach: ISS will vote case-by-case on shareholder proposals seeking reduction of greenhouse gas (GHG) emissions, considering a number of factors.
- New guidelines: ISS will continue to vote case-by-case on shareholder proposals seeking reduction of GHG emissions. However, it will no longer deem *per se* problematic proposals that are “overly prescriptive” in seeking reductions of emissions by specific amounts or within specific timeframes and apparently will no longer take into account feasibility limitations arising out of a company’s current product lines and technologies. Key factors will be: (1) whether the company discloses year-over-year GHG emissions performance data; (2) whether company disclosure lags behind industry peers; (3) the company's actual GHG emissions performance; (4) the company's current GHG emission policies, oversight mechanisms and related initiatives; and (5) whether the company has been the subject of recent, significant violations, fines, litigation or controversy related to GHG emissions.

## Glass Lewis (GL) Guidelines for 2015 Proxy Season

### Reduction or Removal of Shareholder Rights without Shareholder Approval

- Existing approach: GL will consider a withhold recommendation against the governance committee chair if the board adopts an exclusive forum bylaw without shareholder approval.
- New guidelines: GL's 2015 guidelines introduced a significantly broader policy with respect to issuing withhold recommendations in response to the board's adoption or amendment of bylaw (or, where applicable, charter) provisions without shareholder approval. Under the revised policies, GL will consider a withhold recommendation against the governance committee chair or the entire governance committee (depending on the circumstances) if the board, without shareholder approval, amends the company's charter or bylaws to "reduce or remove important shareholder rights, or to otherwise impede the ability of shareholders to exercise such right." As examples of board actions that may justify such a withhold recommendation, GL lists: elimination of shareholders' ability to call special meetings or act by written consent; increase to the ownership threshold for shareholders to call special meetings; increase to vote requirements for charter or bylaw amendments; limitations on shareholders' ability to pursue full legal recourse (such as bylaws that require arbitration of shareholder claims or fee-shifting bylaws); classification of the board; and elimination of shareholders' ability to remove directors without cause.

### Fee-Shifting Bylaws; Mandatory Arbitration Bylaws; Exclusive Forum Provisions

- Existing approach: GL's voting guidelines do not expressly address fee-shifting bylaws or bylaws requiring arbitration of shareholder claims.
- New guidelines: The revised GL policies "strongly oppose" fee-shifting bylaws. According to GL, such bylaws "will likely have a chilling effect on even meritorious shareholder lawsuits as shareholders would face an [sic] strong financial disincentive not to sue a company." Accordingly, under the 2015 guidelines, GL will recommend against the governance committee if a company adopts a fee-shifting bylaw without shareholder approval – even if such bylaw is adopted prior to an IPO, notwithstanding GL's general one-year post-IPO grace period. GL is also opposed to bylaws that would require arbitration of matters that could otherwise have been properly handled through litigation.

### Exclusive Forum Provisions

- Existing approach: GL will generally recommend against exclusive forum provisions unless the company (1) provides a compelling argument why the provision would directly benefit shareholders, (2) provides evidence of abuse of legal process in other non-favored jurisdictions and (3) maintains a strong record of good corporate governance practices. In addition, GL generally recommends against the governance committee chair if exclusive forum provisions are adopted without shareholder approval.
- New guidelines: GL amended its guidelines to add one more requirement – a "narrow tailoring" concept – that companies must satisfy in order to obtain a recommendation in favor of an exclusive forum charter or bylaw provision that is put to a vote. Under the new guidelines, GL will recommend against such provisions unless the company satisfies the three requirements of its historical approach *and* narrowly tailors the exclusive forum provision to the risks involved. Withhold recommendations will also continue to be expected in the case of board-adopted exclusive forum provisions without shareholder approval.

### Director Compensation Bylaws

- Existing approach: GL does not have a policy expressly providing for withhold recommendations if a board adopted a director compensation bylaw without a shareholder vote.
- New guidelines: GL added to its voting policies that it will recommend a vote against all members of the governance committee where the board adopts, without shareholder approval, charter or bylaw provisions that, through rules regulating director compensation, may inhibit the ability of shareholders to nominate alternative director candidates. Although the guidelines do not say so explicitly, GL is presumably joining ISS in taking aim at “director compensation,” or “golden leash,” bylaws, which would protect against incentive bonus schemes whereby activists agree to make special payments to dissident director nominees if they are elected and manage to effect changes in corporate strategy consistent with the activist shareholder’s agenda.

### Board Responsiveness to Majority-Approved Shareholder Proposals

- Existing approach: Under the 2014 policies, GL will recommend against governance committee members during whose tenure the board failed to implement a shareholder proposal “with a direct and substantial impact on shareholders and their rights” that received enough votes (at least a majority) to allow the board to implement the proposal. As examples of such proposals, GL cited declassification and majority vote proposals.
- New guidelines: GL amended its voting policies to expand the circumstances under which failure to implement a shareholder proposal will justify a withhold recommendation. Under the 2015 policies, GL will recommend against governance committee members during whose tenure the board failed to adequately implement a shareholder proposal “relating to important shareholder rights” that received support from a majority of votes cast (excluding abstentions and broker non-votes). As examples of such proposals, GL added to the list proposals seeking a shareholder right to call special meetings. GL’s 2015 guidelines further clarify that in determining whether a board has sufficiently implemented a proposal, GL will examine the “quality” of the right enacted or proffered by the board for any conditions that may “unreasonably interfere” with the right, such as “overly restrictive procedural requirements” for calling a special meeting.

### Exceptions to Post-IPO Grace Period

- Existing approach: GL generally does not issue any voting recommendations on the basis of corporate governance practices for one year following a company’s IPO in recognition of the special circumstances faced by new public companies. However, it will nonetheless recommend against (1) directors who, pre-IPO, adopt a shareholder rights plan and either do not commit to submitting it to shareholder vote within 12 months of the IPO or do not provide a sound rationale for it and (2) the chair of the governance committee who, pre-IPO, adopts an exclusive forum provision.
- New guidelines: The 2015 guidelines provide two new exceptions (in addition to the two existing exceptions) to the general rule that ISS will not issue voting recommendations in the year following an IPO. Under the new guidelines, GL will consider recommending against directors who, pre-IPO, adopt a classified board structure and either do not commit to submitting it to a shareholder vote within 12 months of the IPO or do not provide a sound rationale for it. Additionally, as noted, GL will recommend voting against governance committee members who, pre-IPO, adopt a fee-shifting bylaw.

### Board Leadership Structures

- Existing approach: GL will not recommend withhold votes simply because a company combines the roles of CEO and chair, although it will generally recommend in favor of shareholder proposals seeking separation of the chair and CEO positions and/or the appointment of an independent chair, even where a board has a lead director structure.
- New guidelines: While GL will not recommend withhold votes as a result of a combined chair/CEO position, it now will recommend a vote against the chair of the governance committee where the company has neither an independent chair nor an independent lead director. In addition, GL will continue to generally recommend in favor of separation proposals and independent chair proposals.

### Director Independence

- Existing approach: GL imposes stricter independence standards than those of stock exchange listing standards and securities laws and will deploy withhold recommendations in order to encourage boards to consist of at least two-thirds of directors who qualify as “independent” under GL criteria (as opposed to “inside” or “affiliated” directors). A director will be deemed to lack independence if, among other reasons, he or she is employed by a professional services firm (such as a law firm, investment bank or consulting firm) to which the company pays \$120,000 or more for services.
- New guidelines: A footnote to the revised guidelines clarifies that a director nonetheless may be found to be independent if the payment to the professional services firm employing such director represents less than 1% of its annual revenues and the board provides a “compelling reason” as to why the director’s independence is not affected by the relationship. The revised policies otherwise continue to reflect GL’s stringent independence standards.

### One-Off Compensation Awards and Employee Stock Purchase Plans

- Existing approach: GL’s guidelines do not specifically address one-off compensation awards or employee stock purchase plans.
- New guidelines: A new guideline was added that (1) warns shareholders to be wary of compensation awards granted outside of a company’s standard short-term and long-term incentive schemes and (2) advises companies to redesign their compensation programs rather than make such “one-off compensation awards.” Companies that do make one-off awards are instructed to provide a thorough description of such awards, including an explanation as to why the awards are required, why existing awards are not adequate and how the one-off awards will affect the company’s regular compensation arrangements. Separately, GL has confirmed it is generally supportive of employee stock purchase plans and has provided its method for evaluating such plan proposals.

### Clawbacks

- Existing approach: GL’s existing guidelines include a limited discussion of “clawbacks” to be applied under the Dodd-Frank Act.
- New guidelines: GL provides in its 2015 guidelines that clawback policies should be (1) subject to limited board discretion and (2) triggered upon a restatement of financial results or similar indicators upon which bonuses were based, to allow the company to recoup bonuses if performance goals were not actually achieved.