

# Alert

## SEC Disclosure and Corporate Governance

### Heads Up for 2013 Proxy Season:

### Guidance for How to Address ISS & Glass Lewis Policy Changes

Institutional Shareholder Services Inc. (ISS) and Glass Lewis & Co. have each made several important revisions to their proxy voting policies for the 2013 proxy season.<sup>1</sup> Yesterday, ISS released new and updated FAQs relating to application of ISS proxy voting policies to compensation (including peer groups and realizable pay), board responsiveness to shareholder proposals, hedging and pledging of company stock, and other matters.<sup>2</sup> This Alert provides guidance to US companies on how to address these policy changes.

#### *Overview of Key Changes in Proxy Voting Policies*

- **Effective Dates:** Proxy voting policy changes are applicable to shareholder meetings held on or after:
  - January 1, 2013 – Glass Lewis
  - February 1, 2013 – ISS
- **Board Responsiveness:**
  - Beginning 2014, ISS will recommend a negative vote against directors if the board “failed to act” on a shareholder proposal supported by *a majority of votes cast in the previous year*.
  - Glass Lewis will scrutinize the board’s responsiveness where *25 percent or more* of shareholders vote against the recommendation of management on *any* proposal (not just say-on-pay).
- **Pay-for-Performance:**
  - ISS will consider a company’s self-selected peers when constructing the peer group that ISS will use to evaluate pay-for-performance.
  - ISS will also incorporate a comparison of “realizable pay” to grant date pay into the qualitative portion of its pay-for-performance evaluation.
- **Say-on-Golden Parachutes:**
  - ISS will no longer grandfather existing change-in-control severance agreements.
- **Hedging and Pledging of Company Stock:**
  - ISS will recommend a negative vote on directors if directors and/or executive officers have *hedged any amount or pledged a significant amount* of company stock.

- **“Overboarded” Directors:**
  - ISS will count the boards of publicly-traded subsidiaries as *separate* from the parent board.
- **Other Changes:**
  - ISS has adopted policy changes relating to board and committee meeting attendance, social and environmental shareholder proposals, sustainability metrics for compensation and lobbying disclosure.
  - Glass Lewis has adopted policy changes relating to equity compensation plan proposals and exclusive forum provisions.
- Note that for the 2013 proxy season, ISS has identified more than *40 circumstances* that may support a negative vote recommendation (either “against” or “withhold”) in uncontested director elections (see **Appendix**).
- For a comparison of ISS’ policies (as updated) against suggestions for board structure and practice by influential members of the corporate, institutional investor and legal communities, see our “Comparison of Corporate Governance Principles & Guidelines: United States,” available at <http://www.weil.com/news/pubdetail.aspx?pub=11385>.

## 1. Board Responsiveness

### ISS

ISS’ policy has been to recommend a negative vote against the *entire board* (except new nominees, who are considered case-by-case) where the board “failed to act” on a proposal that received either support of (a) the majority of shares cast the previous year and also one of the two years prior to that, or (b) the majority of shares *outstanding* the previous year.

ISS has changed this approach in two important respects. First, effective for the 2013 proxy season, rather than board non-responsiveness triggering a negative recommendation for the entire board, ISS will recommend against individual directors, committees or the entire board as it deems appropriate. Second, beginning in 2014, ISS will broaden its view of board non-responsiveness. If a shareholder proposal receives a *majority of shares cast at a single shareholder meeting*, ISS will evaluate how the company responded.

Under this revised policy, to be judged “responsive” will generally mean “full implementation” of the shareholder proposal. If implementation of the shareholder proposal requires a shareholder vote, ISS will expect a management proposal designed to implement the earlier shareholder proposal on the next annual meeting ballot. If the board’s response to the proposal involves less than full implementation, ISS will consider the following factors in determining its recommendation:

- Subject matter of the proposal
- Shareholder support and opposition to the proposal at prior meetings
- Board outreach to shareholders after the vote (as disclosed)
- Board actions in response to engagement with shareholders
- Continuation of the underlying issue as a voting item on the ballot (as either a shareholder or management proposal)

- Other factors as appropriate

ISS FAQs include examples of how ISS would treat certain actions taken in response to shareholder proposals on particular topics:<sup>3</sup>

- Board declassification:
  - *Responsive* – declassification, which may be phased in
  - *Not responsive* – all other actions
- Independent chair:
  - *Responsive* – separating chairman and CEO positions, with an independent director elected chairman. Adopting a policy to separate the positions upon the resignation of the current CEO would also be “highly responsive”
  - *Case-by-case* – for other actions, will depend on the responses of shareholders obtained by the company’s outreach, the company’s disclosure of those responses and the facts and circumstances (e.g., strengthening the lead director role may be sufficient where shareholders are concerned about weaknesses in the lead director’s responsibilities)
- Majority voting in director elections:
  - *Responsive* – adoption of true majority vote standard in charter or bylaws
  - *Not responsive* – adoption of director resignation policy alone (without a true majority vote standard)
- Shareholder right to call a special meeting:
  - *Not responsive* – giving shareholders the right to call a special meeting at a higher threshold than that specified in the proposal (e.g., adopting a 25 percent threshold when the shareholder proposal sought a 10 percent threshold), requiring that only one shareholder meet the threshold or restricting allowable agenda items at special meetings called by shareholders
  - *Case-by-case* – if the company discloses outreach efforts to shareholders on the issue and has an equity structure that indicates that a higher threshold is reasonable
- Shareholder right to act by written consent:
  - *Responsive* – granting ability to act by written consent, which may include reasonable restrictions such as:
    - Ownership threshold of no greater than 10 percent
    - No restrictions on agenda items
    - Total review and solicitation period of no more than 90 days
    - Limits on when written consent may be used of no more than 30 days after a meeting already held or 90 days before a meeting already scheduled
    - Requirement that the solicitor must use best efforts to solicit consents from all shareholders
  - *Case-by-case* – restrictions that go beyond those listed above will be considered in light of the company’s disclosure of outreach to shareholders on what they consider reasonable and the equity structure of the company

- Reducing supermajority voting requirements:
  - *Responsive* – reducing all voting requirements to a majority of shares cast
- Shareholder proposals that are antithetical to shareholder rights
  - *Responsive* – companies are not expected to act on proposals that are contrary to the interests of all shareholders and/or proposals that have been invalidated by court rulings or state law

### ***Glass Lewis***

Currently, Glass Lewis scrutinizes board responsiveness, including efforts to engage with shareholders, where 25 percent or more of shareholders (excluding abstentions and broker non-votes) vote against management's say-on-pay proposal. Beginning in January of 2013, Glass Lewis will extend this same approach to situations where 25 percent or more of shareholders vote:

- Against management's recommendation on any proposal – not just say-on-pay – including votes against directors or
- In favor of any shareholder proposal

This scrutiny will involve a review of the underlying issues, whether the board “responded appropriately” based on publicly available information (such as SEC filings, press releases, the company website and other public communications) and the disclosure in the proxy statement in the year following the vote. In assessing board responsiveness, Glass Lewis will undertake a case-by-case assessment, focusing on:

- Changes in board and committee composition, related person transaction disclosure, meeting attendance and director responsibilities
- Amendments to governance documents
- Changes in company policies, business practices or special reports
- Modifications to the design and structure of the company's compensation program

### ***What To Do Now?***

- The ISS and Glass Lewis policy changes will add significant pressure on boards to act in line with shareholder viewpoints, even where the vote result is non-binding and, in the case of Glass Lewis, even where the vote result that triggers the scrutiny represents a minority of shareholders. In this environment, it is important for boards and their counsel to apply the engagement techniques honed in the context of say-on-pay to shareholder proposals generally. In particular, boards should:
  - Engage with their largest shareholders to seek support
  - Consider ways of addressing shareholders' expressed views that the board believes may be acceptable from the company's perspective
  - Be prepared to negotiate with shareholder proposal proponents
- Consider enhanced solicitation efforts with respect to management proposals and director nominees, particularly where there may be circumstances or reasons to believe that a proposal and/or one or more directors may receive a significant negative vote.

- Boards will need to be especially careful to ensure that they continue to apply fiduciary judgment with respect to matters that receive a majority of votes cast on issues for which shareholders do not have decision rights. Directors retain legal responsibility as fiduciaries for those decisions. Communicating to shareholders about how the board is responding and why the board's viewpoint may be different will become increasingly important.

## 2. Pay-for-Performance Evaluation

### *Peer Group Composition: More Attention to Self-Selected Peers*

In making say-on-pay vote recommendations, ISS starts with an analysis of a company's pay practices and performance relative to an ISS-selected peer group. ISS' construction of peer groups has been a source of concern for many companies as its reliance on the company's six-digit Global Industry Classification Standard (GICS) industry group can result in a peer group that is not wholly reflective of a company's multiple business lines (e.g., by omitting key competitors or including companies with very little relevance).

According to its revised methodology, ISS' selected peer group will continue to be comprised of 14 to 24 companies, based on the following factors:

- GICS industry classification of the subject company (8-digit, 6-digit and 4-digit)
- GICS industry classification of the company's disclosed peer group used for CEO pay benchmarking purposes (8-digit, 6-digit and 4-digit)
- Size constraints for both revenue (or assets for certain financial companies) and market value

ISS will prioritize peers that:

- Are in the company's peer group
- Have chosen the company as a peer
- Are closer in size to the company
- Maintain the company size at or near the median of its peer group

This new approach is broadly similar to the Glass Lewis approach (effective July 2012), which considers a company's self-selected peers and the peers disclosed by the company's self-selected peers.

Even though ISS has said that it will take into consideration a company's self-selected peers, ISS FAQs clarify that a company's self-selected peers may not always appear in the ISS peer group, even if they meet ISS' size constraints (for example, if inclusion would lead to over-representation of a particular industry in the ISS peer group).<sup>4</sup> In addition, ISS peer groups will not include privately-held or foreign-domiciled companies that are not domestic issuers for SEC filing purposes (i.e., Form 10-K filers). Likewise, ISS will not incorporate market indices and broad benchmarking surveys in its peer group, even if a company uses such benchmarking tools.

### *Realizable Pay*

Under its revised policy, ISS will compare CEO "realizable pay" with grant date pay in its pay-for-performance analysis, to reflect final payouts of performance-based awards or changes in value due to stock price movements. Realizable pay will be comprised of cash paid, equity-based grants made, changes in pension value and nonqualified deferred compensation earnings and "all other compensation" (such as perquisites) paid during a particular performance period. Realizable pay will

be calculated using stock price at the end of the period, and will be based on equity award values for earned awards or target values for ongoing awards.

ISS has suggested in FAQs that companies include disclosure of ongoing or completed performance-based equity awards to facilitate ISS' calculation of realizable pay, for example:<sup>5</sup>

| <i>Grant Date</i> | <i>Threshold Payout (#)</i> | <i>Target Payout</i> | <i>Maximum Payout</i> | <i>Performance Period*</i> | <i>Target/Actual Earned Date</i> | <i>Actual Payout</i> |
|-------------------|-----------------------------|----------------------|-----------------------|----------------------------|----------------------------------|----------------------|
| 3/1/2009          | 100,000                     | 150,000              | 200,000               | 1 year                     | 6/1/2010                         | 180,000              |
| 3/1/2010          | 150,000                     | 200,000              | 250,000               | 3 years                    | 6/1/2012                         | Not determined yet   |

\*Performance period does not include time-vesting requirement.

According to ISS FAQs, ISS' research reports for S&P 500 companies will include a chart comparing realizable pay to granted pay over a three-year period (which for 2013 will consist of fiscal years 2010 through 2012). ISS may explore the underlying reasons behind why realizable pay is lower or higher than granted pay. Moreover, ISS will consider realizable pay for all companies in determining whether the company demonstrates a strong commitment to a pay-for-performance philosophy.

#### ***What To Do Now?***

- Review the peer companies used for CEO benchmarking purposes in light of the increased weight that such companies will have in ISS' peer group methodology.
- ISS will construct peer groups using the new methodology in early January 2013. Companies that changed their self-selected peer companies with respect to 2012 compensation decisions from those disclosed in the most recent proxy statement were requested by ISS to notify it by December 21, 2012 to ensure that ISS' analysis considers the company's current and most relevant peers. Peer groups will be updated again by ISS during July and August 2013. ISS has indicated in FAQs that companies with later fiscal year ends will be given an opportunity after the 2013 proxy season to communicate changes to peer groups.
  - Companies should be aware that ISS may adjust peer groups by applying "manual judgment" where the standard methodology would produce "inappropriate" peers, so it will still not be possible for companies to predict with any certainty what peer group ISS will use.
- Review existing compensation disclosures and include realizable pay disclosure where appropriate, particularly if the company is in the S&P 500.

### **3. Say-on-Golden Parachutes**

Say-on-golden parachute votes will continue to be analyzed by ISS on a case-by-case basis, but legacy change-in-control severance agreements will no longer be treated as grandfathered (and therefore not subject to scrutiny). Under its revised policy, ISS will focus on *existing* change of control arrangements with named executive officers, as well as recently adopted or amended agreements that are the focus of the current policy. Recent amendments to agreements that incorporate problematic features would carry greater weight in ISS' analysis and the existence of multiple legacy problematic features in change of control agreements (such as cash severance that is more than three times salary

and bonus, excise tax gross-ups and single or modified-single trigger cash severance) will be more closely scrutinized.

#### *What To Do Now?*

- Review change-in-control arrangements – including legacy arrangements – to ascertain the company’s vulnerability under ISS’ revised policy.
- Consider omitting provisions that ISS views as problematic from new or renewed employment agreements and consider negotiating with executive officers to amend agreements that are currently in effect.

#### **4. Hedging and Pledging of Company Stock**

ISS has revised its policy on voting on director nominees in uncontested elections to clarify that a “material failure of risk oversight” includes “any amount” of hedging of company stock or “significant pledging” of company stock, in addition to bribery, large or serial regulatory fines or sanctions and significant adverse legal judgments or settlements.<sup>6</sup> The rationale accompanying the change in policy and ISS FAQs explain that the focus is on hedging and pledging by company executives and directors. Moreover, ISS FAQs indicate that ISS appears to be concerned about company stock purchased on the open market, as well as equity compensation.<sup>7</sup> According to FAQs, ISS will determine on a case-by-case basis whether a “significant” amount of company stock has been pledged by “measuring the aggregate pledged shares in terms of common shares outstanding or market value or trading volume.”<sup>8</sup>

ISS has indicated that at companies where executives and/or directors currently have pledged company stock, the following factors will be considered when determining the voting recommendation:

- Proxy statement disclosure of a policy prohibiting future pledging activity
- Aggregate pledged shares in terms of total common shares outstanding, market value or trading volume
- Disclosure of progress in reducing the magnitude of aggregate pledged shares over time
- Proxy statement disclosure that shares subject to stock ownership and holding requirements do not include pledged company stock
- Other relevant factors

#### *What To Do Now?*

- Determine whether executives and/or directors have hedged and/or pledged company stock, and ensure that appropriate disclosure is included in the proxy statement.
- Review insider trading and other relevant policies and consider whether such policies should be amended to include provisions prohibiting pledging (and perhaps, more broadly, hedging) of company stock by executives and directors.
  - Note that the SEC has not yet begun rulemaking required by the Dodd-Frank Act with respect to disclosure as to whether any employee or director is permitted to hedge against losses on their company stock.



## 5. “Overboarded” Directors

### *ISS*

ISS will recommend a vote against a director who sits on more than six public company boards or who is a public company CEO sitting on the board of more than two public companies besides their own. Under its current policy, ISS counts the boards of a parent company and a publicly-traded subsidiary as a single board. The revised policy will count the parent company board and the board of a *subsidiary with publicly-traded stock owned 20 percent or more by the parent as two separate boards*. Subsidiaries that only issue debt will still be counted as one board along with the parent company board under the new policy.

If a public company CEO is “overboarded,” he or she will receive a negative vote recommendation with respect to outside boards, which as of next year, will include subsidiaries that are less than 50 percent controlled.

### *Glass Lewis*

Under its 2013 guidelines, if an executive officer serves on more than two other boards, Glass Lewis has stated that it will recommend a vote against the director at the public companies where he or she serves as an outside director, but not at the company where he or she is an executive officer.

#### *What To Do Now?*

- Given that “overboarding” results in an automatic negative vote recommendation from ISS, directors should consider whether it is worthwhile to sit on the boards of subsidiary companies.
- Review D&O questionnaires to ensure that relationships between boards on which directors serve are clear.

## 6. Attendance at Board and Committee Meetings

Under its existing policy, ISS issues negative voting recommendations against the *entire board* (except new nominees, who are considered case-by-case) where the company’s proxy statement disclosure indicates that not all directors attended at least 75 percent of the aggregate board and committee meetings, but does not disclose which directors are involved. Beginning in 2013, ISS will recommend that shareholders vote against an *individual director* where it is unclear whether the director attended at least 75 percent of board and committee meetings held during that director’s period of service.

#### *What To Do Now?*

- Review proxy statement disclosure relating to director attendance to ensure that directors who did not attend 75 percent of board and committee meetings are identified and consider disclosing the reasons for any non-attendance.<sup>9</sup>
  - For example, ISS considers it acceptable to miss meetings because of medical issues/illness or family emergencies, or where the director missed only one meeting (when the total of all meetings is three or fewer).

## 7. Evaluating Social and Environmental Shareholder Proposals

ISS’ revised policy establishes enhancement or protection of shareholder value as the overarching principle for evaluating social and environmental shareholder proposals. ISS will continue to consider



other factors, including the cost and benefits of implementing the proposal, the scope of information already available, and the company's response to the issue raised in the proposal.

#### ***What To Do Now?***

- Address the likely impact of the proposal on shareholder value when drafting proxy statement disclosure in opposition to a social or environmental shareholder proposal.

### **8. Sustainability Metrics for Compensation**

ISS' current policy is to recommend that shareholders vote "against" proposals to link, or report on linking, executive compensation to environmental and social criteria issues (e.g., environmental performance, human rights and community involvement). Beginning in 2013, ISS will make recommendations on such proposals on a case-by-case basis, taking into account:

- Factors relating to the history of sustainability issues at the company
- Relevant management systems and oversight mechanisms
- Incorporation of sustainability metrics in executive compensation practices at peer companies
- Disclosure regarding environmental and social performance

#### ***What To Do Now?***

- Review peer company use of sustainability metrics and consider whether it would be appropriate to implement such metrics at the company.
- Consider providing voluntary disclosure relating to environmental and social performance, for example, by publishing a sustainability report.

### **9. Lobbying Disclosure**

Under its existing policy, ISS will make case-by-case recommendations on proposals requesting information on a company's direct and grassroots lobbying activities. ISS has expanded the scope of its policy to include *indirect* lobbying, as well as application of the policy to proposals seeking disclosure of a company's *lobbying policies and procedures*.

#### ***What To Do Now?***

- Consider disclosing information about the company's political activities, which is an emerging best practice, particularly since the recent surge in popularity of shareholder proposals targeting political contributions and lobbying.

### **10. Equity-based Compensation Plan Proposals**

Glass Lewis will examine equity compensation plans that are presented for shareholder approval for share-counting provisions that understate the potential dilution or cost to common shareholders. For example, Glass Lewis' 2013 abridged guidelines state that "plans should not count shares in ways that understate the potential dilution, or cost, to common shareholders. This refers to 'inverse' full value award multipliers."

***What To Do Now?***

- Review methodology for counting shares as set forth in equity compensation plans presented to shareholders for approval.
- Provide proxy statement disclosure explaining how shares are counted pursuant to the terms of the equity compensation plan.

**11. Exclusive Forum Provisions**

Glass Lewis will continue to oppose exclusive forum provisions, but beginning in 2013 may consider recommending in favor of exclusive forum proposals if the company:

- Has a compelling reason why the provision would benefit shareholders
- Provides evidence of abuse of legal process in non-favored jurisdictions
- Demonstrates a record of good corporate governance

***What To Do Now?***

- Review proxy statement disclosure accompanying management proposals to adopt exclusive forum provisions to address Glass Lewis' concerns.

***What You Should Do Now***

ISS typically provides companies that are in the S&P 500 with prior warning if it intends to issue a negative vote recommendation. Companies then have a very narrow time window (48 hours) in which to engage with ISS on the issue. Companies that are not in the S&P 500 generally do not receive such prior warning. We encourage all companies to become familiar with the circumstances in which ISS may recommend a negative vote regarding director re-election (set forth in the **Appendix**), or on other proposals that may be included in their proxy statement. Companies may also wish to contact their analyst at ISS in anticipation of or shortly after proxy statement filing to talk through any issues that could cause ISS to issue a negative vote recommendation.

In addition to the steps discussed above relating to each policy change, we recommend that counsel:

- Review the company's corporate governance and compensation practices for potential vulnerabilities under ISS' and Glass Lewis' policy updates (for example, how shareholder proposals fared at the previous annual meeting and whether executive officers or directors have pledged company stock for margin accounts or other loans)
- Assist the company in developing outreach tactics to engage with key institutional investors on governance-related matters, especially if the company had a majority-supported shareholder proposal at its last annual meeting that has not been implemented
- Review the company's existing compensation and governance disclosure and plan to make improvements where appropriate

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If you have any questions on these matters, please do not hesitate to speak to your regular contact at Weil, Gotshal & Manges LLP or to any member of the Firm's Public Company Advisory Group:

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*We thank our colleague Rebecca Grapsas for her contribution to this Alert.*

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## Appendix

### Circumstances in Which ISS Will Make a Negative Vote Recommendation in Uncontested Director Elections in 2013

According to ISS proxy voting policies applicable to shareholder meetings held on or after February 1, 2013, ISS has identified more than 40 circumstances that may support a negative vote recommendation. These circumstances are outlined below. Changes from ISS' 2012 policies are noted in italics.

#### Individual Directors, Committee Members or the Entire Board

ISS will recommend a negative vote (“against” or “withhold”) for directors individually, committee members or the entire board due to:

##### *Governance failures:*

- Material failures of governance, stewardship, risk oversight (*examples include bribery, large or serial fines or sanctions from regulatory bodies, significant adverse legal judgments or settlements, hedging of company stock, or significant pledging of company stock*), or fiduciary responsibilities at the company
- Failure to replace management as appropriate
- Egregious actions related to service on other boards that raise substantial doubt about the director's ability to effectively oversee management and serve the best interests of shareholders at any company

##### *Board responsiveness:*

- *For 2013, the board failed to act on a shareholder proposal that received approval by a majority of shares outstanding the previous year*
  - *Responding to the shareholder proposal will generally mean either full implementation of the proposal or a management proposal on the next annual ballot to implement the proposal if a shareholder vote is required*
  - *Responses that involve less than full implementation will be considered on a “case-by-case” basis, taking into account:*
    - *Subject matter of the proposal*
    - *Level of support and opposition provided to the proposal at past meetings*
    - *Disclosed outreach efforts by the board to shareholders in the wake of the vote*
    - *Board actions in response to shareholder engagement*
    - *Continuation of the underlying issue as a voting item on the ballot (as either shareholder or management proposals)*
    - *Other factors as appropriate*
  - *Prior to its 2013 policy updates, ISS would issue a negative vote recommendation against the entire board (except new nominees, who were considered on a “case-by-case” basis) but not individual directors or committee members*

- *For 2013, the board failed to act on a shareholder proposal that received approval by a majority of votes cast in the last year and one of the two previous years*
  - *See above discussion relating to board responsiveness*
  - *Prior to its 2013 policy updates, ISS would issue a negative vote recommendation against the entire board (except new nominees, who were considered on a “case-by-case” basis) but not individual directors or committee members*
- *Beginning 2014, the board failed to act on a shareholder proposal that received approval by a majority of votes cast in the previous year*
  - *See above discussion relating to board responsiveness*

### **Individual Directors**

In addition to the circumstances discussed above, ISS will recommend a negative vote (“against” or “withhold”) for an individual director:

#### ***Attendance:***

- *Who attends less than 75 percent of board and committee meetings for the period of service (or missed more than one meeting, if the director’s total service was three or fewer meetings) unless the absence was due to medical issues or family emergencies, and the reason for such absence is disclosed in the proxy statement or other SEC filing*
- *If the proxy disclosure is unclear and insufficient to determine whether the director attended at least 75 percent of board and committee meetings during the period of service*
  - *Prior to its 2013 policy updates, ISS would issue a negative vote recommendation against the entire board (except new nominees, who were considered on a “case-by-case” basis) but not individual directors*

#### ***“Overboarding:”***

- *Who sits on more than six public company boards, with boards of subsidiaries with publicly-traded stock counting as separate boards*
- *Who is CEO of a public company and sits on boards of more than three public companies in total, with boards of subsidiaries with publicly-traded stock counting as separate boards (the negative vote recommendation will apply only to elections for the outside boards but not the boards of controlled subsidiaries and affiliates of the CEO’s own board)*

#### ***Independence:***

- *Who is an inside or affiliated outside director serving on the audit, compensation or nominating committee*

### **Entire Board**

In addition to the circumstances discussed above relating to the entire board, ISS will recommend a negative vote (“against” or “withhold”) for all directors (except for new nominees, who will be considered on a “case-by-case” basis) if:

***Board responsiveness:***

- At the previous board election, any director received more than 50 percent negative votes of the votes cast and the company failed to address the underlying issue(s) that caused these high negative votes
- The board failed to act on takeover offers where a majority of shareholders tendered their shares
- The board implemented an advisory vote on executive compensation on a less frequent basis than the frequency that received the majority of votes cast at the most recent shareholder meeting at which shareholders voted on the say-on-pay frequency
- On a “case-by-case” basis: when no say-on-pay frequency received a majority and the board implements an advisory vote on executive compensation on a less frequent basis than the frequency that received a plurality of the votes cast at the most recent shareholder meeting at which shareholders voted on the say-on-pay frequency, taking into account:
  - The board’s rationale for selecting a frequency that is different from the frequency that received a plurality
  - The company’s ownership structure and vote results
  - ISS’ analysis of whether there are compensation concerns or a history of problematic compensation practices
  - The previous year’s support level on the company’s say-on-pay proposal

***Problematic takeover defenses:***

- The board is classified and a continuing director responsible for a problematic governance issue at the board/committee level that would warrant a negative vote recommendation is not up for election (ISS may hold any or all appropriate nominees, except new nominees, accountable)
- The board lacks accountability and oversight, coupled with sustained poor performance relative to peers measured by one-year and three-year total shareholder returns in the bottom half of a Russell 3000 company’s four-digit Global Industry Classification Group (ISS will consider “problematic” governance provisions including a classified board structure, a supermajority vote requirement, a plurality vote standard in uncontested director elections or majority vote standard for director elections with no carve-out for contested elections, inability of shareholders to call special meetings or act by written consent, a dual-class capital structure, and/or a non-shareholder approved poison pill, and will also take into consideration the company’s five-year total shareholder return and operational metrics)
- A poison pill has a dead-hand or modified dead-hand feature, in which case a negative vote recommendation will be made every year until the feature is removed
- The board adopts a poison pill with a term of more than 12 months or renews any existing pill including a pill with a term of 12 months or less without shareholder approval (a commitment or policy that puts a newly adopted pill to a binding shareholder vote may potentially offset a negative vote recommendation)
- The company maintains a poison pill that was not approved by shareholders (ISS will review annually for companies with classified boards and at least once every three years for companies with declassified boards)

- The board makes a “material adverse change” to an existing poison pill without shareholder approval
- On a “case-by-case” basis: the board adopts a poison pill with a term of 12 months or less without shareholder approval, taking into account the following factors:
  - The date of the pill’s adoption relative to the date of the next meeting of shareholders (whether the company had time to put the pill on the ballot for shareholder ratification given the circumstances)
  - The company’s rationale
  - The company’s governance structure and practices
  - The company’s track record of accountability to shareholders

***Problematic compensation practices:***

- On a “case-by-case” basis: in exceptional circumstances, if the company’s previous say-on-pay proposal received the support of less than 70 percent of votes cast (see below)
- In the absence of a say-on-pay vote or in egregious situations if:
  - There is a significant misalignment between CEO pay and company performance (see below)
  - The board exhibits a significant level of poor communication and responsiveness to shareholders
  - The company fails to submit one-time transfers of stock options to a shareholder vote
  - The company fails to fulfill the terms of a burn rate commitment made to shareholders
  - The company maintains significant “problematic pay practices” (see below)
- The company has recently practiced or approved problematic pay practices (see below)

***Problematic audit-related practices:***

- On a “case-by-case” basis: poor accounting practices rising to a level of serious concern (such as fraud, misapplication of GAAP, and material weaknesses identified in Section 404 disclosures) are identified, taking into consideration the practices’ severity, breadth, chronological sequence and duration, and the company’s efforts at remediation or corrective actions

**All Inside Directors and Affiliated Outside Directors**

ISS will recommend a negative vote (“against” or “withhold”) for all inside directors and affiliated outside directors when:

- The company lacks an audit, compensation, or nominating committee so that the full board functions as that committee
- The company lacks a formal nominating committee (even if the board attests that independent directors fulfill the functions of such a committee)
- The full board is less than majority independent

**Audit Committee Members**

In addition to the circumstances discussed above relating to committee members, ISS will recommend a negative vote (“against or withhold”) for audit committee members if:



- Non-audit fees paid to the auditor are excessive (e.g., non-audit fees are greater than audit fees plus audit-related fees plus tax compliance/preparation fees)
- The company receives an adverse opinion on its financial statements from its auditor
- There is persuasive evidence that the audit committee entered into an inappropriate indemnification agreement with its auditor that limits the ability of the company or its shareholders to pursue legitimate legal recourse against the audit firm
- On a “case-by-case” basis: poor accounting practices, which rise to a level of serious concern (such as fraud, misapplication of GAAP, and material weaknesses identified in Section 404 disclosures) are identified, taking into consideration the practices’ severity, breadth, chronological sequence and duration, and the company’s efforts at remediation or corrective actions

### **Compensation Committee Members**

In addition to the circumstances discussed above relating to committee members, ISS will recommend a negative vote (“against” or “withhold”) for compensation committee members (and potentially the full board) if:

- On a “case-by-case” basis: the company’s previous say-on-pay proposal received the support of less than 70 percent of votes cast, taking into account:
  - The company’s response, including:
    - Disclosure of engagement efforts with major institutional investors regarding the issues that contributed to the low level of support
    - Specific actions taken to address the issues that contributed to the low level of support
    - Other recent compensation actions taken by the company
  - Whether the issues raised are recurring or isolated
  - The company’s ownership structure
  - Whether the support level was less than 50 percent, which would warrant the highest degree of responsiveness
- In the absence of a say-on-pay vote or in egregious situations if:
  - There is a significant misalignment between CEO pay and company performance, considering:
    - Peer group alignment (total shareholder return and CEO’s total pay rank within a peer group as measured over one-year and three-year periods and considering the multiple of CEO total pay relative to the peer group median)
    - Absolute alignment (difference between the trend in annual CEO pay changes and the trend in annualized company total shareholder return over the prior five years)
    - Qualitative factors
  - The board exhibits a significant level of poor communication and responsiveness to shareholders
  - The company fails to submit one-time transfers of stock options to a shareholder vote
  - The company fails to fulfill the terms of a burn rate commitment made to shareholders

- The company maintains significant “problematic pay practices,” such as:
  - Repricing or replacing of underwater stock options/SARS without prior shareholder approval (including cash buyouts and voluntary surrender of underwater options)
  - Excessive perquisites or tax gross-ups, including any gross-up related to personal use of corporate aircraft, executive life insurance, bonus, a secular trust or restricted stock vesting
  - New or extended agreements that provide for:
    - Change in control payments exceeding three times base salary plus bonus
    - Change in control severance payments without involuntary job loss or substantial diminution of duties (“single” or “modified single” triggers)
    - Change in control payments with excise tax gross-ups (including “modified” gross-ups)
- The company has recently practiced or approved “problematic pay practices,” which include (in addition to those listed above):
  - Egregious employment contracts (contracts containing multi-year guarantees for salary increases, non-performance based bonuses, and equity compensation)
  - Overly generous new-hire package for new CEO (excessive “make whole” provisions without sufficient rationale or any problematic pay practice)
  - Abnormally large bonus payouts without justifiable performance linkage or proper disclosure (includes performance metrics that are changed, canceled or replaced during the performance period without adequate explanation of the action and the link to performance)
  - Egregious pension/supplemental executive retirement plan payouts (inclusion of additional years of service not worked that result in significant benefits provided in new arrangements or inclusion of performance-based equity or other long-term awards in the pension calculation)
  - Dividends or dividend equivalents paid on unvested performance shares or units
  - Excessive perquisites, perquisites for former and/or retired executives (such as lifetime benefits, car allowances, personal use of corporate aircraft, or other inappropriate arrangements) or extraordinary relocation benefits (including home buyouts)
  - Internal pay disparity (excessive differential between CEO total pay and that of next highest-paid named executive officer)
  - Voluntary surrender of underwater options by executive officers (may be viewed as an indirect option repricing/exchange program especially if those cancelled options are returned to the equity plan, as they can be regranted to executive officers at a lower exercise price, and/or the executives subsequently receive unscheduled grants in the future)
  - Other pay practices deemed problematic but not covered in any of the above categories

## End Notes

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- 1 ISS, *US Corporate Governance Policy 2013 Updates* (November 16, 2012), available at <http://www.issgovernance.com/files/2013USPolicyUpdates.pdf>. An abridged version of the Glass Lewis guidelines is available at [http://www.glasslewis.com/assets/uploads/2012/02/Guidelines\\_UnitedStates\\_2013\\_Abridged.pdf](http://www.glasslewis.com/assets/uploads/2012/02/Guidelines_UnitedStates_2013_Abridged.pdf).
  - 2 ISS, *2013 US Proxy Voting Policies and Procedures, Frequently Asked Questions on Peer Group Selection Methodology* (December 4, 2012), available at <http://www.issgovernance.com/policy/USPeerGroupFAQ> (hereinafter, “ISS Peer Group FAQs”); ISS, *2013 US Proxy Voting Policies and Procedures, Frequently Asked Questions on Compensation* (December 20, 2012), available at <http://www.issgovernance.com/files/2013ISSC omprehensiveCompFAQ.pdf> (hereinafter, “ISS Compensation FAQs”); ISS, *2013 US Proxy Voting Policies and Procedures, Frequently Asked Questions (Excluding Compensation-related Questions)* (December 20, 2012), available at <http://www.issgovernance.com/files/2013ISSFAQPoliciesandProcedures.pdf> (hereinafter, “ISS Non-Compensation FAQs”).
  - 3 ISS Non-Compensation FAQs 11-14.
  - 4 ISS Peer Group FAQs; ISS Compensation FAQs 16.
  - 5 ISS Compensation FAQs 11.
  - 6 Note that in addition to hedging and pledging, “bribery, large or serial regulatory fines or sanctions and significant adverse legal judgments or settlements” were added to ISS’ policy for 2013 as examples of “material failures of risk oversight.” This was not a policy change as ISS already considered these issues to be problematic and highlighted them in proxy advisory reports for several companies in the past.
  - 7 In FAQs relating to this policy change, ISS notes that “[s]tock-based compensation or open market purchases of company stock should serve to align executives’ or directors’ interests with shareholders.” ISS Compensation FAQs 20; ISS Non-Compensation FAQs 10.
  - 8 ISS Non-Compensation FAQs 10.
  - 9 Companies are already required by SEC rules to disclose the name of any director who attended fewer than 75 percent of board and committee meetings held during that director’s period of service. Item 407(b)(1) of Regulation S-K.