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SEC Disclosure and Corporate Governance

Heads Up for the 2015 Proxy Season:

ISS Spotlight on Independent Chair Shareholder Proposals and Equity Compensation Plans

ISS Seeks Comment on Proposed Changes to Two Proxy Voting Policies by October 29, 2014

On October 15, 2014, Institutional Shareholder Services ("ISS") released proposed amendments to its proxy voting policies for the 2015 proxy season. ISS is seeking comments by 6:00 p.m. EDT on **October 29, 2014**.[1] ISS has stated that it expects to release its final 2015 policies on or around November 7, 2014. The policies as revised will apply to meetings held on or after February 1, 2015.

Proposed Amendments to ISS Proxy Voting Policies for 2015

As discussed below, ISS is proposing two sets of changes to its proxy voting policies for US companies: one relating to shareholder proposals seeking independent board chairs and the other relating to approval of equity compensation plans.

While the proposed amendments are significant, they are also notable for what they do ***not*** include. ISS has ***not*** proposed changes relating to the following topics that were discussed in its 2015 Benchmark Policy Consultation:[2]

- Absolute magnitude of CEO compensation
- Relationship between performance-based compensation award goals and award values
- Forward-looking compensation program disclosure
- Accountability for risk and audit oversight
- Unilateral adoption or amendment of bylaws (including for IPO companies)
- Boardroom gender diversity
- Quantitative environmental and social performance goals
- Application of ISS proxy voting policy to "cross-market companies" (i.e., companies incorporated outside the US that are full US reporting companies listed only on a US exchange)

Moreover, except in the context of independent chair shareholder proposals, the topic of director tenure is ***not*** squarely addressed. Note that director tenure continues to be a factor considered by ISS in its determination of a US company's QuickScore governance rating. It remains to be seen whether ISS is shelving director tenure as a potential policy change for now, only to resurrect it for the 2016 proxy season, for example, as a factor disqualifying a director from being considered "independent" pursuant to ISS policy.

Independent Chair Shareholder Proposals

According to ISS, shareholder proposals calling for an independent board chair were the most prevalent type of shareholder proposal in 2014. ISS recommended "for" 30 of the 62 proposals that came to a vote in 2014, and "against" 32 of the proposals. The proposals received average support of 31.2% of votes cast and four received the support of a majority of votes cast.

For the 2015 season, ISS proposes to adjust its policy by providing a "more holistic review of each company's board leadership structure, governance practices, and financial performance."[3] As revised, ISS would continue to generally recommend "for" independent chair shareholder proposals after consideration in a holistic manner of the factors listed below, some of which are to be incorporated into its analysis for the first time. Moreover, under the proposed revisions, any single factor that may have previously resulted in a "for" or "against" recommendation may be mitigated by other positive or negative factors.

- ***Proposed – NEW:*** The absence or presence of an executive chair
- ***Proposed – NEW:*** Recent board and executive leadership transitions
- ***Proposed – NEW:*** Director/CEO tenure
- ***Existing – REVISED:*** Whether the company has exhibited sustained poor total shareholder return (TSR) performance. This is defined as five-year TSR in the bottom half of the company's four digit industry group, unless there has been a change in the CEO position within that time. Under its existing policy, ISS considers one-year and three-year TSR; it is unclear whether ISS will continue to consider one-year TSR (in addition to five-year TSR) under the revised policy
- ***Existing – No Change:*** Whether the company designates a lead director, who is elected by and from the independent directors and has clearly delineated and comprehensive duties
- ***Existing – No Change:*** Whether the board is at least two-thirds independent
- ***Existing – No Change:*** Whether the key board committees are fully independent
- ***Existing – No Change:*** Whether the company has disclosed governance guidelines
- ***Existing – No Change:*** Whether the company has any problematic governance or management issues (for example, egregious compensation practices, multiple related-party transactions or other issues putting director independence at risk, corporate or management scandals, excessive problematic corporate governance provisions, or flagrant actions by management or the board with potential or realized negative impacts on shareholders)

The proposed policy changes do not elaborate on how ISS will incorporate the new proposed factors into its analysis, when one of the new factors will be viewed as having a positive or negative impact, or the weightings that may be applied to each factor. For example, ISS has not indicated the proportion of long-tenured directors on a board that ISS would consider to be problematic. In addition, ISS has not indicated the length of tenure that it will consider problematic, although ISS considers director tenure of nine years to be "lengthy" for purposes of its QuickScore governance ratings applicable to US companies.[4] ISS classifies directors of European companies as non-independent if they have served on the board for twelve or more years.[5]

Although it remains to be seen how ISS will apply its revised policy in practice, ISS notes that backtesting of the new methodology using data for the companies targeted in 2014 resulted in a higher level of support *for* independent chair proposals. It is possible that the presence of an independent lead director with robust responsibilities may no longer persuade ISS to issue a recommendation "against" such a proposal even where the company fulfills ISS' other criteria. This risk seems particularly acute where a company has recently transitioned to a combined chair/CEO where the roles were previously separated, or where the board has appointed a separate executive chair. ISS cites disapprovingly the recent decision of the board of directors of Bank of America to repeal a shareholder-sponsored binding bylaw amendment mandating an independent chair that received majority support from shareholders in 2009, to enable it to recombine the positions of chair and CEO.

ISS seeks specific feedback on the following issues:

- Factors considered most important when determining whether an independent chair shareholder proposal warrants support
- Weight given to recent changes in board leadership structure
- Timeframe that ISS should use when assessing financial performance when evaluating independent chair shareholder proposals

New Equity Plan Scorecard

Under its existing policy, ISS recommends that shareholders vote "against" equity-based compensation plans if the plan fails *any one* of the following tests: the total cost of the plan is unreasonable; repricing is expressly permitted; a pay-for-performance misalignment is found; the company's three-year burn rate exceeds the burn rate cap of its industry group; the plan has a liberal change-in-control definition; *or* the plan is a vehicle for problematic pay practices.

For the 2015 season, ISS has announced that it will use a new "scorecard" model for evaluating equity compensation plans, by considering a range of proposed positive and negative factors. Scorecard factors will be weighted by reference to company size and status (i.e., S&P 500, Russell 3000, Non-Russell 3000 and Recent IPOs or Bankruptcy Emergent companies).

ISS' new scorecard approach to evaluating equity plans will result in increased scrutiny on historical equity grant practices other than burn rate -- under existing policy, these are not explicitly considered by ISS when formulating its recommendations on equity plan proposals. Moreover, it is not yet clear what factors ISS would consider to be problematic (for example, what the minimum vesting period should be).

- The specific data points that ISS will consider as part of its new scorecard approach -- including equity grant activity over the past three years -- are discussed below in connection with ISS' new Equity Plan Data Verification Portal.

The key proposed scorecard factors are as follows:

- *Plan cost:* the total potential cost of the company's equity plans relative to industry/market cap peers, measured by the company's estimated shareholder value transfer (SVT) in relation to peers
  - SVT is currently measured using an ISS proprietary binomial option pricing model that assesses the amount of shareholders' equity flowing out of the company to employees and directors, and is expressed as a dollar amount and as a percentage of market value
  - SVT will now be calculated for both (a) new shares requested plus shares remaining for future grants, plus outstanding unvested/unexercised grants, and (b) only on new shares requested plus shares remaining for future grants, thereby eliminating ISS' option overhang carve-out policy; under its existing policy, SVT included the new shares proposed, shares available under existing plans and shares granted but unexercised
- *Plan features:*
  - Automatic single-triggered award vesting upon a change-in-control
  - Discretionary vesting authority
  - Liberal share recycling on various award types; this factor would no longer be incorporated in SVT calculations as is the case under existing policy
  - Minimum vesting period for grants made under the plan

- *Grant practices:*
  - The company's three-year burn rate relative to its industry/market cap peers, eliminating commitments from companies to adhere to specific future burn rate caps; burn rate benchmarks will be calibrated for respective index groups (i.e., S&P 500, Russell 3000 and Non-Russell 3000), with the relevant GICS industry classification used within each index group
  - Vesting requirements in the most recent CEO equity grants
  - The estimated duration of the plan based on the sum of shares remaining available and the new shares requested, divided by the average annual shares granted in the prior three years; note that an ISS representative at a recent conference indicated that ISS expects that companies should be prepared to seek shareholder approval of equity plans every four to five years[6]
  - The proportion of the CEO's most recent equity grants/awards subject to performance conditions
  - Whether the company maintains a clawback policy
  - Whether the company has established requirements to hold shares after exercise or vesting

While ISS has not indicated how particular factors will be weighted, it states that some "highly egregious" features will continue to result in negative recommendations regardless of other factors (for example, authority to reprice options without seeking shareholder approval).[7]

ISS has stated that the proposed policy is not designed to change the number of companies that would receive adverse vote recommendations. ISS notes that it has historically recommended against approximately 30% of equity plan proposals and that (nevertheless) the vast majority of plan proposals receive the requisite number of votes to pass.

ISS seeks specific feedback on the following issues:

- Factors that should be more heavily weighted when evaluating equity plan proposals
- Unintended consequences from shifting to a scorecard approach

New ISS Equity Plan Data Verification Portal – Available Now

In mid-August, ISS announced its new Equity Plan Data Verification Portal for ***all US companies*** -- not just the S&P 500 -- submitting equity compensation plans for shareholder approval in proxy statements filed after September 8, 2014. The Portal provides companies that have registered in advance with ISS with the opportunity to review and request modifications to key data points that ISS plans to use to formulate its voting recommendation on the plan. These data points include, among others, outstanding common stock, shares reserved, shares subject to outstanding awards, change in control provisions, tax gross-ups, share recycling and equity grant activity over the past three fiscal years.

ISS has stated that a company's equity compensation plan data will be posted to the Portal "in many cases" within 12 business days following the filing of the definitive proxy statement. Once the data has been posted, companies that have pre-registered with ISS will receive an early morning notification via email that the data has been posted. Such companies will then have approximately ***two business days*** to review data and request modifications. Requests for data modifications must be consistent with relevant SEC filings and other publicly available information. ISS has stated that it will send responses to requests for modifications within five business days of the request.

Data verification will be available to companies subject to ISS' US policy, which includes foreign-incorporated companies that are full US registrants (so-called "cross-market companies"). Data verification will not be available where a company files its proxy statement 30 days or less prior to the meeting date.

What To Do Now?

- Consider providing comments to ISS on the proposed policy changes before the October 29, 2014 deadline
  - Comments can be submitted to ISS via email to policy@issgovernance.com
- Engage with key institutional investors with respect to board leadership matters, especially if the company has or anticipates transitioning to a combined chair/CEO or separate executive chair
- If the company receives an independent chair shareholder proposal, ensure that the board leadership disclosure and the company's statement in response to the proposal included in the proxy statement explain the board's rationale for its leadership structure in the context of the company's own circumstances and discuss feedback received from key investor outreach in connection with the issue
- Review compensation practices for potential vulnerabilities under ISS' proposed policy amendments, particularly if the company anticipates requiring shareholder approval of an equity compensation plan in the near future (for example, when determining performance and vesting conditions of CEO equity awards)
- Companies planning to include an equity compensation plan on the ballot of the next meeting should consider taking the following steps:
  - Determine which company personnel to designate as the contact persons for purposes of receiving the notification that data is available for review. Remember to notify ISS of any changes to contact information. Note that only corporate issuers -- not compensation consultants or other advisors -- can register for access to the Portal
  - Register now with ISS via this link: http://www.issgovernance.com/equity-plan-data-verification-webform/. ISS has stated that it will issue login details within five to seven business days of registration
  - Review the list of verifiable data points set forth in Appendix A of ISS' FAQs, available at http://www.issgovernance.com/file/faq/equity-plan-data-verification-faq.pdf
  - Draft proxy statement disclosure bearing in mind the new scorecard approach and the data points that will be incorporated into ISS' analysis
  - Build time for data verification into the annual meeting timeline, to ensure the availability of in-house personnel and advisors as appropriate when the data is published to the Portal. ISS has stated that data will be available from 9:00am Eastern time on the first business day after the relevant company's data is collected and published to the Portal until 9:00pm Eastern time on the second business day
- Be aware that ISS may make changes to its policies beyond those released for comment: by amending its FAQs (e.g., the FAQ describing how ISS applies its policies to cross-market companies) or by changing the application or interpretation of a broad existing policy (e.g., expansion of the situations that would constitute "extraordinary circumstances" warranting a recommendation "against" directors for material failures of risk oversight)

ENDNOTES

1. ISS' proposed policy changes, questions for comment and details around how to participate in ISS' comment process are *available at* http://www.issgovernance.com/iss-launches-2015-benchmark-policy-consultation/.
2. For a discussion of the ISS 2015 Benchmark Policy Consultation, see Weil Alert, "Two New Proxy Advisory Firm Developments: What They Mean for Corporate Issuers" (July 18, 2014), *available at* http://www.weil.com/~/media/files/pdfs/pcag_sec_discl_alert_july2014.pdf.
3. Although the ISS 2015 Benchmark Policy Consultation did not include policy survey questions relating to independent chair shareholder proposals, it was included as a consultation topic in ISS' long-term benchmark policy consultation period launched in February 2014. Specifically, as part of that consultation, ISS stated that it would be examining alternative approaches to its policy on shareholder proposals seeking an independent chair, including whether to always vote for such proposals or generally vote for such proposals as a matter of best practice but taking into account certain company-specific circumstances on a case-by-case basis that may warrant a combined chair/CEO board leadership structure.
4. ISS, "ISS Governance QuickScore 2.0, Overview and Updates" (most recently updated March 7, 2014) at Question 13, *available for download at* http://www.issgovernance.com/governance-solutions/investment-tools-data/quickscore/.
5. ISS, "2014 European Proxy Voting Summary Guidelines" (most recently updated April 4, 2014) at 14-15, *available at* http://www.issgovernance.com/file/2014_Policies/EuropeanSummaryGuidelines.pdf.
6. Remarks of Carol Bowie, The Proxy Disclosure Conference, Las Vegas, NV (September 29, 2014).
7. Note that in response to ISS' 2015 Benchmark Policy Consultation, issuers and investors provided suggested weightings of categories of the new scorecard factors as follows:
   - Plan cost -- 60% of issuer respondents and 70% of institutional investor respondents weighted this from 30-50%
   - Plan features -- 50% of issuers and 62% of investors weighted this from 25-35%
   - Grant practices -- 61% of issuers and 64% of investors weighted this from 20-35%

   ISS, "2014-2015 Policy Survey Summary of Results" (September 2014) at 7, 13-14, *available at* http://www.issgovernance.com/file/publications/ISS2014-2015PolicySurveyResultsReport.pdf.

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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 Weil's Public Company Advisory Group:

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