SHEARMAN & STERLING LLP

EXECUTIVE COMPENSATION & EMPLOYEE BENEFITS

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ISS Publishes 2015 Draft Policy Changes; Comments Due by October 29, 2014

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On October 15, 2014, Institutional Shareholder Services Inc. ("ISS") published its key draft policy changes for the 2015 proxy season. There are only two proposed updates for the United States. The first introduces a new "scorecard" approach to evaluating management equity compensation plan proposals and the second modifies the independent chair shareholder proposal voting policies. The open comment period closes on October 29, 2014 and ISS's final 2015 US and international voting policies are expected to be released on or around November 7, 2014. The 2015 policies generally will be effective for shareholder meetings of publicly traded companies held on or after February 1, 2015.[1]

Management Equity Compensation Plan Proposals

Under its current policies, ISS uses a series of six "pass/fail" tests to evaluate equity plan proposals. ISS will recommend a vote "Against" an equity plan if the plan "fails" any one of the following tests:

- *The total cost of the company's equity plans is "unreasonable" based on ISS's proprietary shareholder value transfer ("SVT") measure.* SVT assesses "the amount of shareholders' equity flowing out of the company to employees and directors." SVT is expressed as both a dollar amount and a percentage of market value, and includes the new share pool proposed, shares available under existing plans and shares granted but unexercised. A

[1] ISS's press release on the proposed policy changes can be found at http://www.issgovernance.com/iss-launches-2015-benchmark-policy-consultation/.

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company's SVT is reasonable if it falls below the company-specific allowable cap determined by ISS using benchmark SVT levels for the industry.

- *The company's average three-year burn rate exceeds the applicable burn rate cap determined by ISS.*
- *There is a pay-for-performance misalignment and a portion of the CEO's misaligned pay is attributed to non-performance-based equity awards (which ISS defines to include time vesting stock options).*
- *The plan permits repricing or exchange of underwater stock options without prior shareholder approval.*
- *The plan contains a liberal change in control definition.*
- *The equity plan is a vehicle for any of ISS's problematic pay practices.*

ISS's Proposed Equity Scorecard Approach

ISS proposes to use a more nuanced approach to evaluate equity share plan proposals, which would consider a range of positive and negative factors, referred to as the Equity Plan Scorecard ("EPSC"). The EPSC would consider three factors—plan cost, plan features and grant practices. A company's total EPSC score will determine whether a "For" or "Against" recommendation is warranted. The key features of the proposed EPSC include the following:

- *Plan Cost*. The EPSC will review the total potential cost of the company's equity plans relative to peers. ISS will continue to evaluate costs based on SVT in relation to peers; however, SVT will be calculated based on both (1) the aggregate of the new shares requested, the shares remaining for future grants and outstanding unvested/unexercised grants and (2) only the new shares requested plus shares remaining for future grants. This dual cost measurement approach would eliminate ISS's current option overhang carve-out policy.[2]
- *Plan Features*. The EPSC will evaluate the following plan features: (1) automatic single-trigger vesting upon a change in control, (2) discretionary vesting authority, (3) liberal share recycling on various award types and (4) minimum vesting periods for grants made under the plan. The share recycling provisions will no longer be a component of SVT.

[2] Under ISS's current policies, companies with sustained positive stock performance and high overhang costs attributable to in-the-money options that were outstanding for more than six years may receive a carve-out of these options from the overhang calculation, as long as the dilution attributable to the new share request is reasonable and the company exhibits sound compensation practices.

- *Grant Practices*. The EPSC will consider (1) the company's three-year burn rate relative to its peers (this would eliminate company "burn rate commitments"), (2) vesting requirements in the most recent CEO equity grants, (3) the estimated duration of the plan (calculated based on the sum of the shares remaining available and the new shares requested, divided by the average annual shares granted in the prior three years), (4) the proportion of the CEO's most recent equity grants subject to performance conditions, (5) whether the company maintains a clawback policy and (6) whether the company has established post exercise/vesting shareholding requirements.

ISS noted that the scorecard factors and weightings will be keyed to company size and status. While EPSC recommendations will largely be based on a combination of the above factors, certain "highly egregious" features will continue to result in automatic "Against" recommendations regardless of other factors (such as the ability to reprice options without shareholder approval). Thus, ISS may provide a favorable recommendation for a plan whose cost is nominally higher than the company's allowable cap if sufficient positive factors are present. Conversely, a plan where cost is nominally lower than the allowable cap may receive an "Against" recommendation if a preponderance of the EPSC factors is negative.

Independent Board Chair Shareholder Proposals

Current ISS Policy

Under its current policy, ISS will generally recommend a vote "For" shareholder proposal for independent chairs unless the company satisfies all of the following criteria:

- *The company designates a lead director, who is elected by and from the independent board members with clearly delineated and comprehensive duties*;
- *The board is at least two-thirds independent*;
- *The key board committees are fully independent*;
- *The company has disclosed governance guidelines*;
- *The company has not exhibited sustained poor TSR performance (defined as one- and three-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); and*
- *The company does not have any problematic governance issues*.

ISS's Proposed Additional Factors and Holistic Evaluation Approach

ISS proposes adding new governance, board leadership and performance factors to the list of criteria considered when evaluating shareholder proposals for independent chairs, including:

- *Absence/presence of an executive chair*;
- *Recent board and executive leadership transitions at the company*;
- *Director and CEO tenure*; *and*
- *Longer (five-year) TSR performance period*.

In addition, similar to the EPSC proposal, ISS proposes to use a more holistic approach in evaluating these types of proposals. Therefore, a "For" or "Against" recommendation will not be determined by any single factor. Rather, ISS will consider all positive and negative aspects of the company based on the new expanded list of factors when assessing these shareholder proposals.

Comment Period

ISS has invited comments on their proposed policy changes and will publish comments as they are received. Comments must be submitted on or before October 29, 2014 by email to policy@issgovernance.com. In addition to general comments, with respect to the EPSC, ISS seeks specific feedback as to whether (1) certain factors under the EPSC should be more heavily weighted and (2) commentators foresee any unintended consequences from shifting to a scorecard approach. With respect to independent chair shareholder proposals, ISS seeks specific feedback as to (1) the factors that companies consider most important when determining whether an independent chair shareholder proposal warrants support, (2) how much weight companies give to recent changes in board leadership structure, specifying issues and relative weights and (3) the timeframe that ISS should use when assessing financial performance when evaluating independent chair proposals.

ISS's final 2015 US and international voting policies are expected to be released on or around November 7, 2014. The 2015 policies will generally be effective for shareholder meetings of publicly traded companies held on or after February 1, 2015.

Conclusion

As was the case in 2014, ISS has not proposed sweeping changes to their 2015 policies; however, the proposed modifications reflect movement away from rigid policies towards a more flexible, holistic approach.

While the existing "pass/fail" test generally allows a company to predict ISS's recommendation on equity plan proposals prior to filing their proxy, the greater flexibility under the proposed EPSC will result in more uncertainty. Nonetheless, ISS notes that the EPSC is not designed to increase or decrease the number of companies receiving negative vote recommendations.[3] Companies that will be placing equity plans up for shareholder approval in 2015 must consider whether the EPSC will alter expected ISS recommendations and, consequently, whether plan modifications will be required. In reviewing their plans, companies should pay particular attention to outlying terms which have historically not presented impediments to a positive ISS recommendation.

[3] ISS has historically recommended "Against" approximately 30% of equity plan proposals each year; however, the vast majority of plan proposals pass with no more than nine equity plan proposals failing each year over recent years.

Despite the year-over-year increase in the number of independent chair proposals, these proposals have not received significant shareholder support. Under its current evaluation approach, ISS recommended against approximately 50% of these proposals in 2014. However, ISS notes that testing of its new methodology indicates a higher level of support for independent chair proposals in 2015, which will likely have a positive impact on shareholder support. Companies with independent chair proposals on their 2015 ballots should consider how ISS's shift in focus to the governance, board leadership and financial performance factors will affect shareholder support for these proposals.

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