

*Client Alert***ISS and Glass Lewis Update Policies for the 2015 Proxy Season****EXEQUITY**Independent Board and
Management Advisors

Both Institutional Shareholder Services Inc. (ISS) and Glass, Lewis & Co., LLC (Glass Lewis) have issued their policy updates for the 2015 proxy season. This *Client Alert* focuses on their policy updates concerning compensation matters.

ISS

ISS published its 2015 policy updates on November 6, 2014, which will be effective for meetings on or after February 1, 2015.¹ The only policy regarding compensation officially “updated” for the 2015 proxy season concerns equity-based and other incentive plan proposals.

Equity Plan Proposals

As proposed in its draft policies, ISS adopted a “scorecard” model to evaluate equity plan proposals, which ISS refers to as the Equity Plan Scorecard or EPSC policy. Under the EPSC policy, ISS will weigh a number of factors under three categories (referred to as EPSC pillars by ISS): Plan Cost, Grant Practices, and Plan Features. Each of the three EPSC pillars will be weighted differently to arrive at an EPSC score which will inform ISS’s vote recommendation on the plan proposal. ISS indicated that “[m]ore information about the policy and weightings will be included in ISS’s Compensation FAQ to be published in December.”²

The chart below lays out the factors under and weighting of each EPSC pillar that ISS mentioned in the final policy announcement for S&P 500 and Russell 3000 companies:

Plan Cost	Grant Practices	Plan Features
45%	35%	20%
<ul style="list-style-type: none"> SVT*—ABC shares* (50%) SVT*—AB shares* (50%) 	<ul style="list-style-type: none"> 3-year average burn rate CEO vesting term (most recent awards) Equity clawback policy Plan duration Holding requirement Performance grant ratio (CEO) 	<ul style="list-style-type: none"> Change-in-control single-trigger vesting Liberal share recycling Minimum vesting Non-change-in-control vesting discretion

* Descriptions of these factors are provided on the following page.

¹ United States Proxy Voting Guidelines Update, 2015 Benchmarking Policy Recommendations, November 6, 2014, available at:

<http://www.issgovernance.com/file/policy/2015USPolicyUpdates.pdf>.

² Ibid, p.10.

On November 20, 2014, ISS Corporate Solutions (ISS CS) hosted a webinar, *ICS Overview of 2014 ISS Research Policy Updates*, which offered a bit more detail on the ISS policy updates for 2015, especially the EPSC policy. ISS CS indicated that ISS Research will utilize four different weighting schemes for the EPSC pillars: S&P 500 companies, the remainder of the Russell 3000 companies, non-Russell 3000 companies, and IPO/post-bankruptcy companies. There will be a single threshold passing EPSC score for each of these groups. ISS CS also indicated that there would still be “deal breakers” which would lead to ISS Research opposing a proposed plan despite a passing EPSC score.

Under the Plan Cost pillar, ISS will be looking at the cost of shares using its shareholder value transfer (SVT) methodology. The two groups of shares are ABC shares and AB shares, where:

- “A” shares are shares being requested in the new plan;
- “B” shares are shares available for grant under existing and continuing plans; and
- “C” shares are outstanding full-value awards and unexercised stock options and stock appreciation rights.

ISS CS also indicated that ISS Research would determine separate SVT allowable caps for both ABC shares and AB shares for each company. Currently ISS looks only at the SVT for ABC shares. With the change to review the SVT of both ABC shares and AB shares, ISS has announced it will no longer honor stock option carve-outs which were used when in-the-money stock options had been outstanding for a prolonged period.

Under the Grant Practices pillar, ISS will be looking at several factors as set out in the chart on the first page. ISS CS also detailed *preliminary* burn rate benchmarks for 2015 (2015 burn rate caps) as part of its presentation.³ ISS will have three groups now: S&P 500 companies, Russell 3000 companies (excluding S&P 500 companies), and Non-Russell 3000 companies. Previously ISS had only used two groups: Russell 3000 companies and Non-Russell 3000 companies. The burn rate caps shown for the S&P 500 companies are significantly lower than those for the Russell 3000 companies (excluding the S&P 500) and appear to be significantly lower than the 2014 burn rate caps which would have applied based on Global Industry Classification Standard (GICS) group. Conversely, the burn rate caps for Russell 3000 companies (excluding S&P 500 companies) look like they will increase slightly compared to the Russell 3000 companies (including S&P 500 companies) burn rate caps for 2014. But, companies should keep in mind that having a burn rate above their applicable burn rate cap will not necessarily automatically cause ISS to recommend against their plan proposal (as was previously the case). Instead, under the EPSC policy, an excessive burn rate is one factor weighed against a plan proposal under the Grant Practices pillar (exactly how the burn rate will weigh into this factor is not yet known).

In adopting the EPSC policy, ISS also announced that burn rate commitments would no longer be accepted under the 2015 policies. Under the Plan Features pillar, ISS will be examining the plan document itself to determine if it:

- Provides for single-trigger vesting of equity awards upon a change-in-control;
- Prohibits repricing, exchanges, and cash buyouts;
- Includes minimum vesting periods for awards;
- Prohibits liberal share recycling;

³ See the Appendix for the Preliminary Burn Rate Benchmark for 2015 that ISS CS announced.

- Contains liberal change-in-control vesting risk;
- Gives the committee full discretion to accelerate awards outside a change in control;
- Excludes evergreen provisions;
- Excludes excise tax gross-ups; and
- Prohibits option reloading.

Equity Commentary: Many aspects of the new EPSC policy remain unknown, including the specific weighting of factors under each EPSC pillar as well as the “deal breakers” that will cause ISS to oppose a proposed plan regardless of whether it otherwise achieves a passing EPSC score. Hopefully the impending Compensation FAQ will address these issues and provide a better understanding of how ISS Research will, in fact, apply this new policy.

As we do not know yet how ISS will weigh the plan features it will be examining, we suggest companies be a bit flexible in their plan drafting to enable modification to respond to any clarifications by ISS that could make including specified provisions in their proposed plan desirable. Once ISS issues its Compensation FAQ in December, we will review and provide information on the weightings ISS will use for the various groups as well as the individual EPSC pillar’s factors.

In the meantime, U.S. companies that will be taking an equity plan proposal to shareholders on or after February 1, 2015 should sign up for ISS Equity Plan Data Verification. This data verification is provided by ISS without charge to companies and will provide two business days to review the data that ISS Research collects on the Equity Plan Proposal. Companies can find out more information and register for the data verification service at: <http://www.issgovernance.com/equity-plan-data-verification>.

S&P 500 companies should review their burn rates in light of the preliminary 2015 Burn Rate Benchmarks. In our view, these burn rate caps represent significant **declines** from last year and may pose an issue for S&P 500 companies that were complying with the old caps, but with little headroom.

Say-on-Pay Policy Application Updates

While ISS did not revise the say-on-pay policy for 2015 per se, it did announce⁴ that it was making some changes to the thresholds of the quantitative tests used in evaluating pay for performance. The thresholds that are changing are as follows (changed thresholds for the 2015 proxy season are bolded):

Quantitative Pay-for-Performance Test	Thresholds for Meetings Before February 1, 2015		Thresholds for Meetings After February 1, 2015	
	Medium	High	Medium	High
Relative Degree of Alignment (RDA)	-30	-50	-40	-50
Multiple of Median (MOM)	2.33x	3.33x	2.33x	3.33x
Pay-TSR Alignment (PTA)	-30	-45	-20	-35

ISS has left the thresholds for the MOM test the same as last year: medium concern at or above 2.33x, and high concern at or above 3.33x.

⁴ Get Ready for the 2015 Proxy Voting Season, November 20, 2014; a replay of the webcast can be accessed at: <http://www.issgovernance.com/iss-2015-policy-updates-webinar/>.

Exequity Commentary: *The increase in the medium threshold for RDA will likely help companies avoid triggering a medium concern under RDA this year (as ISS's back-testing of this change seems to confirm). The lowering of the PTA medium and high thresholds is sure to snag more companies this year than in the past, so the change may not make all that much difference in the ultimate number of "Against" vote recommendations ISS issues on say-on-pay proposals. However, companies that thought they would not have any issues with the quantitative tests for 2015 may now face a medium concern under PTA. Companies should test this and, if true, should consider ways to directly address the pay-performance alignment in the proxy.*

Glass Lewis

Glass Lewis also issued its updated policies for 2015,⁵ which apply to shareholder meetings on or after January 1, 2015. The two policy updates/discussions related to compensation that were included in the Glass Lewis 2015 policy updates include a discussion on aspects of the say-on-pay proposal and a discussion of how Glass Lewis approaches employee stock purchase plan (ESPP) proposals.

Say-on-Pay Policy

For this policy, Glass Lewis provided a discussion of how it handles one-off awards granted outside existing incentive programs under its say-on-pay policy. Glass Lewis believes shareholders should be wary of such awards and thinks that if existing programs fail to offer adequate compensation, those programs should be redesigned.

Glass Lewis does acknowledge that in certain circumstances additional incentives may be appropriate (but it does not provide examples of such circumstances). Glass Lewis recommends that if a company makes such one-off awards outside its normal compensation programs, the company should provide a thorough description of the awards, along with a cogent and convincing explanation of why such awards were necessary and why existing awards do not provide sufficient motivations. Companies making such awards should also indicate if and how the regular compensation arrangements will be affected by the supplemental awards. Glass Lewis will review the terms and size of such grants in the context of a company's overall incentive strategy and granting practices, as well as the current operating environment.

Employee Stock Purchase Plan (ESPP) Policy

Glass Lewis indicated that it uses a quantitative model to estimate the cost of a proposed ESPP that measures the expected discount, purchase period, and expected purchase activity (if previous ESPP activity disclosed), and whether the plan has a "look-back" feature, and then compares the cost to the costs of ESPPs at similar companies.

Glass Lewis generally will support an ESPP (except in extreme circumstances) that utilizes the \$25,000 qualified ESPP limit per employee per year under the U.S. tax code. Glass Lewis also looks to see if the proposed ESPP will cause significant dilution to shareholders and whether it will last an extended period of time. Glass Lewis generally will oppose ESPPs that contain an evergreen provision.

⁵ Proxy Paper Guidelines, 2015 Proxy Season, An Overview of the Glass Lewis Approach to Proxy Advice, United States; available at: http://www.glasslewis.com/assets/uploads/2013/12/2015_GUIDELINES_United_States.pdf.

Peer Group Update

Glass Lewis has partnered with Equilar for the past several years and now uses the Equilar Peers for a company in its pay-for-performance analysis. If a company has changed the peers it used in setting compensation for this past year and will be detailing a new/revised peer group in its next proxy, it should consider providing the updated/new peer group list to Equilar to ensure that Glass Lewis uses its updated peer group when conducting its pay-for-performance analysis. U.S. companies in the Russell 3000 and Canadian companies in the S&P/TSX Composite Index can submit their peer group updates to Equilar before December 31, 2014. To do so, companies should visit the Equilar Peer Update Portal at www.equilar.com/solutions/governance/equilar-market-peers and follow the instructions provided. Note the peer group updates being solicited are for the peer groups that will be disclosed in the next proxy (2015) and related to the prior year's (2014) compensation decisions.

Exequity Commentary: *The Glass Lewis discussion provided as part of its 2015 Policy Update release should help companies better understand what Glass Lewis is analyzing in case of ESPPs and how ISS will approach a pay-for-performance analysis for purposes of determining its say-on-pay proposal vote recommendation. Unlike the ISS approach, which has historically been to offer greater details about its policies and items that would automatically trigger an "Against" vote recommendation from ISS, Glass Lewis has eschewed that approach as being counter to its case-by-case analysis. Unfortunately, the Glass Lewis stance makes it more difficult to anticipate how Glass Lewis is likely to come out on compensation proposals. To some extent Glass Lewis addresses this shortcoming by partnering with Equilar and permitting Equilar to offer pay-for-performance simulations based on the Glass Lewis methodology. However, this issue still exists with respect to equity plan proposals, including ESPP proposals. If a significant portion of a company's shareholder base considers or follows the Glass Lewis vote recommendation, anticipating how Glass Lewis will recommend on such plan proposals will be more difficult than anticipating an ISS vote recommendation on the same proposal (though that may change somewhat this year with ISS's new EPSC policy).*



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Appendix: Preliminary Burn Rate Benchmark for 2015

Global Industry Classification Standard	S&P 500	Russell 3000 (Excluding S&P 500)	Non- Russell 3000
1010—Energy	2.00	4.83	7.46
1510—Materials	2.00	3.05	7.85
2010—Capital Goods	2.10	3.36	8.16
2020—Commercial & Professional Services	2.10	4.56	7.33
2030—Transportation	2.10	3.63	3.69
2510—Automobiles & Components	2.41	4.25	5.95
2520—Consumer Durables & Apparel	2.41	4.67	7.61
2530—Consumer Services	2.41	4.15	4.28
2540—Media	2.41	4.82	5.47
2550—Retailing	2.41	4.54	6.60
3010—Food & Staples Retailing	2.14	3.01	4.45
3020—Food Beverage & Tobacco	2.14	3.01	4.45
3030—Household & Personal Products	2.14	3.01	4.45
3510—Health Care Equipment & Services	2.89	5.12	9.08
3520—Pharmaceuticals, Biotechnology & Life Sciences	2.89	6.16	8.98
4010—Banks	3.17	3.18	2.79
4020—Diversified Financials	3.17	9.58	7.56
4030—Insurance	3.17	3.48	2.58
4040—Real Estate	3.17	2.52	2.68
4510—Software & Services	4.41	7.56	9.14
4520—Technology Hardware & Equipment	4.41	5.66	8.91
4530—Semiconductors & Semiconductor Equipment	4.41	7.05	9.75
5010—Telecommunication Services	2.00	4.47	7.54
5510—Utilities	2.00	2.00	3.66