



# United States

## Sustainability Proxy Voting Guideline Updates

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2015 Policy Recommendations

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## BOARD OF DIRECTORS

### Voting on Director Nominees in Uncontested Elections

#### Unilateral Bylaw/Charter Amendments

**Current Recommendation:** Unilateral bylaw/charter amendments are currently evaluated under the “Environmental, Social and Governance Failures” policy: Under extraordinary circumstances, vote against or withhold from directors individually, committee members, or the entire board, due to:

- › Material failures of governance, stewardship, risk oversight<sup>1</sup>, or fiduciary responsibilities at the company, including failure to guard against or manage ESG risks;
- › Failure to replace management as appropriate; or
- › Egregious actions related to a director’s service on other boards that raise substantial doubt about his or her ability to effectively oversee management and serve the best interests of shareholders at any company.

#### Key Changes:

Adopt a stand-alone policy that codifies the current policy application related to unilateral bylaw/charter amendments.



#### **New Recommendation:** *Unilateral Bylaw/Charter Amendments*

Generally vote against or withhold from directors individually, committee members, or the entire board (except new nominees, who should be considered case-by-case) 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, considering the following factors, as applicable:

- › The board's rationale for adopting the bylaw/charter amendment without shareholder ratification;
- › Disclosure by the company of any significant engagement with shareholders regarding the amendment;
- › The level of impairment of shareholders' rights caused by the board's unilateral amendment to the bylaws/charter;
- › The board's track record with regard to unilateral board action on bylaw/charter amendments or other entrenchment provisions;
- › The company's ownership structure;
- › The company's existing governance provisions;
- › Whether the amendment was made prior to or in connection with the company's initial public offering;
- › The timing of the board's amendment to the bylaws/charter in connection with a significant business development;
- › Other factors, as deemed appropriate, that may be relevant to determine the impact of the amendment on shareholders.

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<sup>1</sup> Examples of failure of risk oversight include, but are not limited to: bribery; large or serial fines or sanctions from regulatory bodies; significant environmental incidents including spills and pollution; large scale or repeat workplace fatalities or injuries; significant adverse legal judgments or settlements; hedging of company stock; or significant pledging of company stock.

### Rationale for Update:

There has recently been a substantial increase in the number of bylaw/charter amendments made by boards that adversely impact shareholder rights without seeking shareholder ratification of the amendments. Given this rise in unilateral amendments, Sustainability Advisory Services has adopted a policy within its Board Accountability policy framework that specifically addresses this issue. Cases of unilateral bylaw/charter amendments were previously evaluated under the Environmental, Social and Governance Failures policy. The policy codifies our current approach to unilateral bylaw/charter amendments.

Accounting for a portion of the increase in unilateral amendments is a recent trend of companies adopting a suite of shareholder-unfriendly governance provisions shortly before, or on the date of, their initial public offerings ("IPOs"). Further, while many investors may not consider pre-IPO adoptions of shareholder-unfriendly provisions to be best governance practice and hold directors accountable for such actions, some may consider these adoptions on a case-by-case basis. The new policy addresses this trend in IPO-related amendments by considering it a factor when determining a vote recommendation on directors.

The policy on unilateral bylaw/charter amendments is in line with investor sentiment as expressed in ISS' 2014-2015 Policy Survey. According to the survey, with regard to evaluating board accountability, 72 percent of investors indicate the board should never adopt amendments that negatively impact investors' rights without shareholder approval. An additional 20 percent indicated a case-by-case approach, depending on the type of bylaw/charter amendment and other factors.

## Other Board-Related Proposals

### Independent Chair (Separate Chair/CEO)

**Current Recommendation:** Generally vote for shareholder proposals requiring that the chairman's position be filled by an independent director, unless the company satisfies *all* of the following criteria:

The company maintains the following counterbalancing governance structure:

- › Designated lead director, elected by and from the independent board members with clearly delineated and comprehensive duties. (The role may alternatively reside with a presiding director, vice chairman, or rotating lead director; however, the director must serve a minimum of one year in order to qualify as a lead director.) The duties should include, but are not limited to, the following:
  - › presides at all meetings of the board at which the chairman is not present, including executive sessions of the independent directors;
  - › serves as liaison between the chairman and the independent directors;
  - › approves information sent to the board;
  - › approves meeting agendas for the board;
  - › approves meeting schedules to assure that there is sufficient time for discussion of all agenda items;
  - › has the authority to call meetings of the independent directors;
  - › if requested by major shareholders, ensures that he or she is available for consultation and direct communication;
- › Two-thirds independent board;
- › Fully independent key committees;
- › Established governance guidelines;
- › A company in the Russell 3000 universe must not have exhibited sustained poor total shareholder return (TSR) performance, defined as one- and three-year TSR in the bottom half of the company's four-digit GICS industry group (using Russell 3000 companies only), unless there has been a change in the chairman/CEO position within that time. For companies not in the Russell 3000 universe, the company must not have underperformed both its

peers and index on the basis of both one-year and three-year total shareholder returns, unless there has been a change in the chairman/CEO position within that time;

- › The company does not have any problematic governance or management issues, examples of which include, but are not limited to:
  - › 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.

**Key Changes:** Update the policy by adding new governance, board leadership, and performance factors to the analytical framework and to look at all of the factors in a holistic manner. New factors considered include: the absence/presence of an executive chair, recent board and executive leadership transitions at the company, director/CEO tenure, and a longer (five-year) TSR performance period.



**New Recommendation:** Generally vote for shareholder proposals requiring that the chairman's position be filled by an independent director, taking into consideration the following:

- › The scope of the proposal;
- › The company's current board leadership structure;
- › The company's governance structure and practices;
- › Company performance; and
- › Any other relevant factors that may be applicable.

Regarding the scope of the proposal, consider whether the proposal is precatory or binding and whether the proposal is seeking an immediate change in the chairman role or the policy can be implemented at the next CEO transition.

Under the review of the company's board leadership structure, the Sustainability policy may support the proposal under the following scenarios absent a compelling rationale: the presence of an executive or non-independent chair in addition to the CEO; a recent recombination of the role of CEO and chair; and/or departure from a structure with an independent chair. The Sustainability Policy will also consider any recent transitions in board leadership and the effect such transitions may have on independent board leadership as well as the designation of a lead director role.

When considering the governance structure, the Sustainability policy will consider the overall independence of the board, the independence of key committees, the establishment of governance guidelines, board tenure and its relationship to CEO tenure, and any other factors that may be relevant. Any concerns about a company's governance structure will weigh in favor of support for the proposal.

The review of the company's governance practices may include, but is not limited to poor compensation practices, material failures of governance and risk oversight, related-party transactions or other issues putting director independence at risk, corporate or management scandals, and actions by management or the board with potential or realized negative impact on shareholders. Any such practices may suggest a need for more independent oversight at the company thus warranting support of the proposal.

The Sustainability policy's performance assessment will generally consider one-, three, and five-year TSR compared to the company's peers and the market as a whole. While poor performance will weigh in favor of the adoption of an independent chair policy, strong performance over the long-term will be considered a mitigating factor when determining whether the proposed leadership change warrants support.

### Rationale for Update:


Calls for independent board chairs were the most prevalent type of shareholder proposal offered for consideration at U.S. companies' annual meetings in 2014. As of June 30, 62 of these proposals were brought to a shareholder vote, up from 55 resolutions over the same time period in 2013. The number of proposals calling for independent board chairs has more than doubled over the past five years.

Recent high-profile board leadership changeovers at Hewlett-Packard and Bank of America may focus investors' attention on directors' decisions to revert to a combined CEO/chair role after years of independent leadership. At Bank of America Corporation, a shareholder-sponsored bylaw amendment mandating an independent chair received majority support from shareholders in 2009. The company's board repealed this provision to allow it to recombine the titles (and created a new lead director position).


Regarding the presence of an executive or non-independent chair in addition to the CEO, a recent academic study<sup>2</sup> found that retention of a former CEO in the role of chair may prevent new CEOs from making performance gains by dampening their ability to make strategic changes at the company. In addition, it is debatable whether a lead independent director can act as an effective counterbalance to both a CEO and an executive chair.

The Sustainability policy believes that a more holistic review of each company's board leadership structure, governance practices, and financial performance will strengthen the application of this policy. 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 aspects, respectively.

### Proxy Access

 **Current Recommendation:** Vote case-by-case on proposals to enact proxy access, taking into account, among other factors:

- › Company-specific factors; and
- › Proposal-specific factors, including:
  - › The ownership thresholds proposed in the resolution (*i.e.*, percentage and duration);
  - › The maximum proportion of directors that shareholders may nominate each year; and
  - › The method of determining which nominations should appear on the ballot if multiple shareholders submit nominations.

 **New Recommendation:** Generally vote for management and shareholder proposals for proxy access with the following provisions:

- › **Ownership threshold:** maximum requirement not more than three percent (3%) of the voting power;
- › **Ownership duration:** maximum requirement not longer than three (3) years of continuous ownership for each member of the nominating group;
- › **Aggregation:** minimal or no limits on the number of shareholders permitted to form a nominating group;
- › **Cap:** cap on nominees of generally twenty-five percent (25%) of the board.

Review for reasonableness any other restrictions on the right of proxy access.

Generally vote against proposals that are more restrictive than these guidelines.

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<sup>2</sup> Quigley, Timothy J. and Hambrick, Donald C., When the Former CEO Stays on as Board Chair: Effects on Successor Discretion, Strategic Change, and Performance (December 6, 2010). *Strategic Management Journal*, 33: 834–859, DOI: 10.1002/smj.1945, July 2012.

**Rationale for Update:**

Vested with clear legal authority by the Dodd-Frank Act, the SEC adopted a [proxy access rule](#) (Rule 14a-11) in August 2010 that provided a thoughtful balance of a number of factors including the ownership threshold and the holding period duration. The DC Circuit Court vacated the rule in July 2011 based on its findings of procedural deficiencies in the SEC's rulemaking process. Prior policy, updated for the 2012 proxy season, largely focused on attempts by shareholder proposal proponents to lower the safeguards against abuse (for example, an extremely low ownership threshold) of the access right that the SEC's formulation addressed. As such, the policy sought to maintain the balance that the SEC struck between protecting shareholders' rights and the potential abuse of the access process. Three years of voting results on both management- and shareholder-sponsored proxy access proposals drawing on the Commission's model appear to validate the SEC's formulation. Moreover, a 2014 [CFA Institute study](#) provides a cost-benefit analysis, which the court said was lacking in the SEC's rulemaking process, and concludes that "proxy access would serve as a useful tool for shareowners in the United States and would ultimately benefit both the markets and corporate boardrooms, with little cost or disruption to companies and the markets as a whole."

For companies that present both a board and shareholder proxy access proposals on the ballot, Taft-Hartley Advisory Services will review each of them under the policy.

## SHAREHOLDER RIGHTS & DEFENSES

### Litigation Rights (including Exclusive Venue and Fee-Shifting Bylaw Provisions)

**Current Recommendation:** None on fee-shifting bylaws. For Exclusive Venue:

Vote case-by-case on exclusive venue proposals, taking into account:

- › Whether the company has been materially harmed by shareholder litigation outside its jurisdiction of incorporation, based on disclosure in the company's proxy statement; and
- › Whether the company has the following good governance features:
  - › An annually elected board;
  - › A majority vote standard in uncontested director elections; and
  - › The absence of a poison pill, unless the pill was approved by shareholders.

**Key Changes:** Expand the Sustainability policy on exclusive venue provisions to cover other types of bylaws which have a material impact on shareholders' litigation rights, such as bylaws which mandate fee-shifting or arbitration.



**New Recommendation:** Bylaw provisions impacting shareholders' ability to bring suit against the company may include exclusive venue provisions, which provide that the state of incorporation shall be the sole venue for certain types of litigation, and fee-shifting provisions that require a shareholder who sues a company unsuccessfully to pay all litigation expenses of the defendant corporation.

Vote case-by-case on bylaws which impact shareholders' litigation rights, taking into account factors such as:

- › The company's stated rationale for adopting such a provision;
- › Disclosure of past harm from shareholder lawsuits in which plaintiffs were unsuccessful or shareholder lawsuits outside the jurisdiction of incorporation;
- › The breadth of application of the bylaw, including the types of lawsuits to which it would apply and the definition of key terms; and
- › Governance features such as shareholders' ability to repeal the provision at a later date (including the vote standard applied when shareholders attempt to amend the bylaws) and their ability to hold directors accountable through annual director elections and a majority vote standard in uncontested elections.

Generally vote against bylaws that mandate fee-shifting whenever plaintiffs are not completely successful on the merits (i.e., in cases where the plaintiffs are partially successful).

Unilateral adoption by the board of bylaw provisions which affect shareholders' litigation rights will be evaluated under the Sustainability's policy on [Unilateral Bylaw/Charter Amendments](#).

#### **Rationale for Update:**

Beginning in 2011, companies began to adopt bylaw provisions intended to limit the venue for shareholder lawsuits to the jurisdiction of incorporation. More recently, companies and their advisers have proposed other types of bylaws intended to limit shareholders' litigation rights. Most notably, a May 2014 Delaware Supreme Court decision opened the door to the adoption by companies of bylaws that would require a shareholder plaintiff who sues the company unsuccessfully to pay the defendant company's litigation expenses. Although the Delaware legislature was widely expected to enact legislation limiting the applicability of the Supreme Court's decision to non-stock corporations, the legislature has not yet done so, and several publicly traded Delaware corporations have already adopted fee-shifting bylaws by way of a board resolution. Should the legislature decline to prohibit such actions by public companies, a large number of companies are expected to adopt such bylaws in 2015 and beyond, either through unilateral board action or by putting such provisions to a shareholder vote. Other types of bylaws impacting litigation rights have been discussed, including provisions which would mandate arbitration instead of litigation, and provisions which would require a plaintiff to demonstrate that his or her case is supported by a significant number of other shareholders in the company. This updated policy sets out a framework for evaluating such bylaw provisions, as well as potential future variants.

## COMPENSATION

### **Equity-Based and Other Incentive Plans**

**Current Recommendation:** Vote case-by-case on equity-based compensation plans. Vote against the equity plan if any of the following factors apply:

- › The total cost of the company's equity plans is unreasonable;
- › The plan expressly permits repricing;
- › 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-of-control definition; or
- › The plan is a vehicle for problematic pay practices.


#### **Key Changes:**

The Sustainability policy is adopting a "scorecard" model (Equity Plan Scorecard -- "EPSC") that considers a range of positive and negative factors, rather than a series of "pass" or "fail" tests, to evaluate equity incentive plan proposals. The total EPSC score will generally determine whether the Sustainability policy recommends for or against the proposal.

EPSC factors will fall under three categories ("EPSC pillars"): Plan Cost, Plan Features, and Grant Practices. As part of the new approach, the updated policy will:



- › Utilize three index groups to determine burn-rate benchmarks (index/industry mean and 1 standard deviation above mean, along with a 2 percent de minimis benchmark) and factor weightings<sup>3</sup>:
  - › S&P500
  - › Russell 3000 (ex-S&P 500)
  - › Non-Russell 3000.
- › Utilize individual scorecards for each index groups (S&P500, Russell3000, Non-Russell3000, and IPOs).
- › Measure plan cost (SVT) by both of the following:
  - › The company's total new and previously reserved equity plan shares plus outstanding grants and awards ("A+B+C shares"), and
  - › Only the new request plus previously reserved but ungranted shares ("A+B shares");
- › Eliminate option overhang carve-outs, in light of the additional SVT evaluation factor for only A+B shares; and
- › Eliminate consideration of "liberal share recycling" provisions from the SVT cost calculations; instead, share recycling will be scored as a negative plan feature.

 **New Recommendation:** Vote case-by-case on equity-based compensation plans depending on a combination of certain plan features and equity grant practices, where positive factors may counterbalance negative factors, and vice versa, as evaluated in three pillars:

- › **Plan Cost:** The total estimated 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 and considering both:
  - › SVT based on new shares requested plus shares remaining for future grants, plus outstanding unvested/unexercised grants; and
  - › SVT based only on new shares requested plus shares remaining for future grants.
- › **Plan Features:**
  - › Automatic single-triggered award vesting upon a change in control (CIC);
  - › Discretionary vesting authority;
  - › Liberal share recycling on various award types;
  - › 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;
  - › Vesting requirements in most recent CEO equity grants (3-year look-back);
  - › 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;
  - › The proportion of the CEO's most recent equity grants/awards subject to performance conditions;
  - › Whether the company maintains a claw-back policy;
  - › Whether the company has established post exercise/vesting share-holding requirements.

Generally vote against the plan proposal if the combination of above factors indicates that the plan is not, overall, in shareholders' interests, or if any of the following apply:

- › Awards may vest in connection with a liberal change-of-control definition;
- › The plan would permit repricing or cash buyout of underwater options without shareholder approval (either by expressly permitting it – for NYSE and Nasdaq listed companies -- or by not prohibiting it when the company has a history of repricing – for non-listed companies);

<sup>3</sup> An additional version of the model will also be developed for companies that recently IPO'd or emerged from bankruptcy, where the burn-rate factor does not apply, per current policy.

- › The plan is a vehicle for problematic pay practices or a pay-for-performance disconnect; or
- › Any other plan features are determined to have a significant negative impact on shareholder interests.

#### Rationale for Update:

As issues around cost transparency and best practices in equity-based compensation have evolved in recent years, ISS' Sustainability policy is updating its Equity Plans policy in order to provide for a more nuanced consideration of equity plan proposals. As an alternative to applying a series of standalone tests (focused on cost and certain egregious practices) to determine when a proposal warrants an "Against" recommendation, the updated approach will incorporate a model that takes into account multiple factors, both positive and negative, related to plan features and historical grant practices.

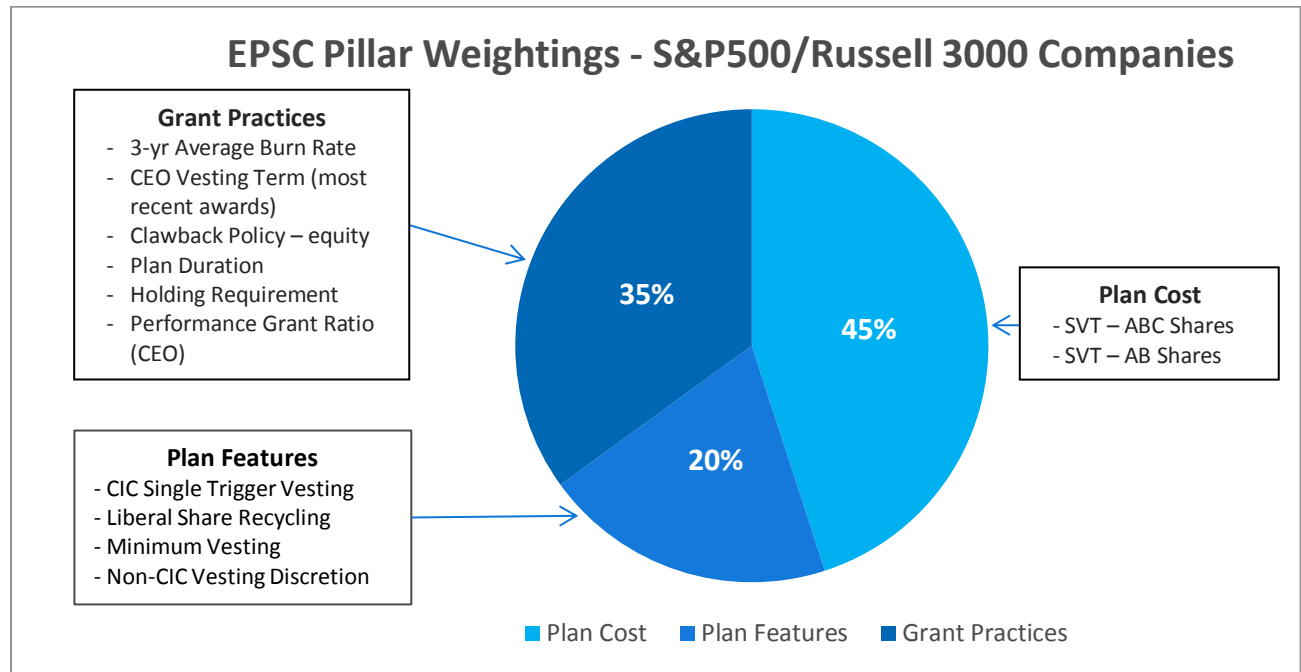
Feedback from institutional investors and corporate issuers in recent years, beginning with the 2011-2012 ISS policy cycle, indicates strong support for the new approach, which incorporates the following key goals:

- › Consider a range of factors, positive and negative, to determine vote recommendations.
- › Select factors based on (1) feedback from institutional investors and other market constituents, (2) recognition of a growing body of best practices in equity compensation, and (3) internal analysis of correlations with TSR performance and plan proposal vote results.
- › Establish burn-rate and Equity Plan Scorecard ("EPSC") factor weightings in keeping with company size (based on three market index groups).
- › Ensure that plans associated with certain highly negative features (e.g., ability to reprice stock options without shareholder approval) or practices (pay-for-performance disconnects driven by excessive equity grants) will receive a negative recommendation.

The Equity Plan Scorecard ("EPSC") policy on equity plan proposals introduces a more nuanced approach around traditional cost evaluation by considering a range of plan features and grant practices that reflect growing investor awareness of aspects such as performance-conditioned awards, risk-mitigating mechanisms, and reasonable plan duration. While some highly egregious features will continue to result in negative recommendations regardless of other factors (e.g., authority to reprice options without seeking shareholder approval), EPSC recommendations will largely be based on a combination of factors related to (1) cost, (2) plan features, and (3) grant practices. For example, a plan where cost is nominally higher than a company's allowable cap may receive a favorable recommendation if sufficient positive factors are present. Conversely, a plan where cost is nominally lower than the allowable cap may ultimately receive a negative recommendation if a preponderance of scorecard factors is negative.

The updated policy is designed to expand the range of factors that investors may consider in determining whether an equity plan serves their long-term interests. With the strong market recovery, investors may be more critical of equity transfers to management in the absence of shareholder friendly plan features and grant practices.

A scorecard approach will enable evaluation of equity plan proposals in consideration of a range of best practices. Weightings for the three scorecard pillars applicable to S&P 500 and Russell 3000 companies are shown below, along with the factors within each pillar. More information about the policy and weightings can be found in ISS' Compensation FAQ that was published in December.



## ENVIRONMENTAL AND SOCIAL ISSUES


### Political Contributions

**Current Recommendation:** Generally vote for proposals requesting greater disclosure of a company's political contributions and trade association spending policies and activities, considering:

- › The company's current disclosure of policies and oversight mechanisms related to its direct political contributions and payments to trade associations or other groups that may be used for political purposes, including information on the types of organizations supported and the business rationale for supporting these organizations; and
- › Recent significant controversies, fines, or litigation related to the company's political contributions or political activities.

### Key Changes:

- › Refine the current policy by indicating separately the factors considered regarding oversight and indirect political contribution activity;
- › Clarify the current policy by specifically noting "management and board" oversight mechanisms are reviewed and considered during application of the policy;
- › Update the current policy regarding reference to trade association disclosure; and
- › Replace "including information on the types of organizations supported and the business rationale for supporting these organizations" with "The company's disclosure regarding its support of, and participation in, trade associations or other groups that may make political contributions."

 **New Recommendation:** Generally vote for proposals requesting greater disclosure of a company's political contributions and trade association spending policies and activities, considering:

- › The company's policies, and management and board oversight related to its direct political contributions and payments to trade associations or other groups that may be used for political purposes;
- › The company's disclosure regarding its support of, and participation in, trade associations or other groups that may make political contributions; and
- › Recent significant controversies, fines, or litigation related to the company's political contributions or political activities.

**Rationale for Update:**

The updated policy specifies the types of oversight mechanisms (i.e., management and board oversight) that the Sustainability policy reviews and considers when applying the policy for greater clarity. Furthermore, the language regarding trade association disclosure is being updated to reflect the evolution of corporate disclosure practices on political contributions that has taken place in recent years. Information that will be incorporated into reviews of disclosures of trade association support or participation includes, but is not necessarily limited to, the comprehensiveness of a company's trade association membership disclosure, the nature of a company's trade association participation, and the level of transparency provided regarding a company's trade association expenditures.

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