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Meridian Client Update

ISS Adopts Final Policy Updates for 2015

On November 6, 2014, Institutional Shareholder Services (ISS) issued final updates to its proxy voting policies that largely reflect the updates as initially proposed by ISS (see Meridian Client Update dated October 17, 2014). The policy updates revise ISS proxy voting policies for U.S. listed companies in the following two areas relating to executive compensation and corporate governance:

- Equity Plan Proposals, and
- Shareholder Proposals to Separate Role of CEO and Board Independent Chair.

These policy updates take effect for shareholder meetings occurring on or after February 1, 2015.

Equity Plan Proposals

ISS is proposing to implement a new method for evaluating equity plan proposals.

Prior Policy

Under its prior policy, ISS evaluates a company's equity plan proposal under six governance standards. A failure to meet any of these standards may result in ISS recommending AGAINST such a plan proposal (particularly a failure to meet a plan's ISS determined "cost" cap).

New Policy

Under its new policy, ISS will evaluate equity plan proposals under a **balanced scorecard** approach. The balanced scorecard approach will consider a range of positive and negative factors, rather than a series of "pass/fail" tests as applied under ISS's prior policy, to evaluate equity plan proposals. These pass/fail tests were predominantly objective in nature. In contrast, the new policy will require ISS to make certain subjective determinations to develop a company's score under the new model. Generally, this score will determine whether ISS will issue a FOR or AGAINST recommendation on a company's equity plan proposal.

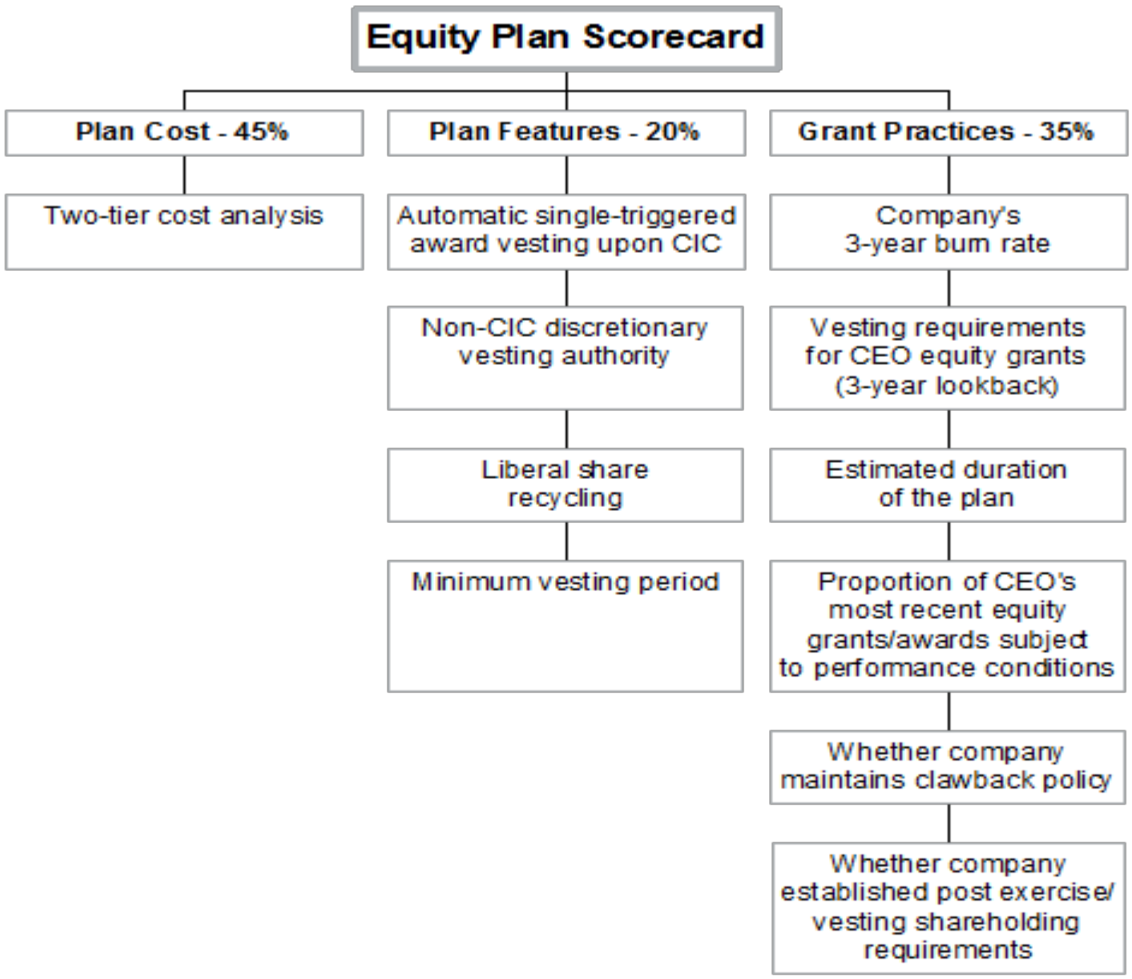
Overview of Balanced Scorecard

Under the balanced scorecard approach, ISS will develop a company's "score" by evaluating various factors that fall under one of three main categories: (1) plan cost, (2) plan features and (3) company grant practices (an overview of the factors under each category follows). ISS will employ separate scoring models for equity plan proposals from S&P 500, Russell 3000 (excluding S&P 500), Non-Russell 3000 companies and recent IPO/bankruptcy emergent companies.

The scorecard is structured so that a "positive" factor may act to mitigate the presence of a "negative" factor. For example, the presence of favorable plan features (e.g., minimum vesting standards, no liberal share recycling, double trigger vesting of equity awards in connection with a change in control) may mitigate ISS concerns regarding excessive equity plan costs or burn rate. Conversely, if ISS identifies provisions that are problematic, ISS might recommend voting AGAINST an equity plan proposal, irrespective of whether the cost of the equity plan meets ISS policy requirements.

Balanced Scorecard Categories, Factors and Weighting

The diagram below shows the factors ISS will consider under each category when evaluating an equity plan proposal and the weight assigned to each category for S&P 500 and Russell 3000 companies.



Generally, ISS will recommend AGAINST an equity plan proposal if the combination of the above factors (based on the applicable weightings) indicates that the plan is not, overall, in shareholders' interests.

Special Circumstances Resulting in a Negative Vote Recommendation

Regardless of the outcome of its evaluation of an equity plan proposal against the balanced scorecard, generally ISS will recommend AGAINST an equity plan proposal if **any** of the following circumstances are present:

- Equity awards may vest in connection with a “liberal change-of-control” definition (i.e., a change in control that is not consummated),

- The equity plan permits 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),
- The equity plan is a vehicle for problematic pay practices or a pay-for-performance disconnect, or
- Any other equity plan feature that is determined to have a significant negative impact on shareholder interests.

Explanation of Category Factors

The Policy Update provides the following limited guidance on the indicated category factors.

Plan Cost

ISS will determine two separate plan "costs" under its proprietary cost model (i.e., shareholder value transfer (SVT) model) as follows:

- ***Tier 1 Cost***. Tier 1 cost will be based on new shares requested, shares remaining for future grants and shares subject to outstanding unvested/unexercised grants.
- ***Tier 2 Cost***. Tier 2 cost will be based on new shares requested and shares remaining for future grants.

These costs will be evaluated against allowable cost caps developed by ISS based on industry and market cap considerations. Under its prior policy, ISS evaluated a single plan cost against a company's applicable cost cap. ISS determined this single plan cost in a fashion similar to the determination of Tier 1 cost under the new policy.

ISS will not take into account the presence of a "liberal share recycling" provision when determining a plan's cost. Liberal share recycling includes returning to the share authorization pool shares used to pay the exercise price of a stock option or shares withheld to cover tax obligations arising upon the exercise of a stock option. However, a liberal share recycling provision is a separate factor evaluated under the Plan Features category under the new policy. Under its prior policy, the presence of a liberal share recycling provision could increase the cost of an equity plan.

Plan Features

The Policy Update provides ***no*** guidance on the factors under the Plan Features category.

Grant Practices

The Policy Update provides limited guidance on the three of the six factors under the Grant Practices category.

- **Burn rate**. Similar to its prior policy, ISS will assess a company's three-year average burn rate against two benchmarks: (i) one standard deviation above the applicable index/industry mean and (iii) 2 percent de minimis burn rate. ISS will determine applicable index/industry means for three separate indices:

  — S&P 500 companies

  — Russell 3000 companies (exclusive of S&P 500 companies)

  — Non-Russell 3000 companies

  Under its prior policy, ISS did not separately determine burn rate caps for S&P 500 companies.

In contrast to ISS's prior policy that permitted a company to mitigate a failed burn rate test by making a prospective burn rate commitment, the new policy will not allow for such mitigation.

- **Duration of plan**. ISS will determine the estimated duration of an equity plan by dividing the sum of shares remaining available for future grants and the new shares requested by a company's three-year average burn rate (denominated in shares).
- **Vesting standards in CEO equity grants**. The Policy Update clarifies that ISS will evaluate the vesting standards in CEO equity grants made over the most ***recent three-year period***.

ISS will provide additional guidance on its new policy on equity plan proposals in a Compensation FAQ to be published in December.

Meridian comment. The balanced scorecard approach presents a mixed bag for companies. The new approach is more complex and less transparent than ISS's prior policy on equity plan proposals. Unless ISS provides significant guidance on a number of the category factors in its upcoming FAQs, a company's ability to determine their plan's compliance with these factors will likely prove problematic. However, a partial silver lining may be found in the weights ISS assigned each scorecard category.

ISS adopted our recommendation that the Plan Cost category be assigned the greatest weight and that the cumulative weight assigned to the Plan Cost and Grant Practices categories equal 80%. These weightings mitigate the significance of the Plan Features category. This should give a company leeway to design their equity plans with only modest consideration for the factors under the Plan Features category.

By satisfying the factors under the Plan Cost category (which is weighted 45%), it would appear possible for a company to derive a favorable score under the new policy by meeting some but not all of the six factors under the Grant Practices category. However, as discussed below, companies will remain in the dark with regard to complying with most of these factors unless ISS's Compensation FAQ provides significant and clear compliance guidance.

- **Clawback policy**. Generally, the implementation of a clawback policy should not prove onerous for most companies. This is evidenced by the growing majority of large public companies that already maintain clawback policies (independent of Sarbanes-Oxley clawback requirement). The Policy Update does not specify if ISS will require a clawback policy to include specific terms and conditions other than it cover equity compensation. However, we believe it is likely that ISS will consider as adequate the typical clawback policy under which a company has the discretion to recoup specified compensation amounts due to a financial restatement.
- **Shareholding policy**. Unlike clawback policies, shareholding policies are not as widespread since most companies use share ownership guidelines as the sole or primary method for requiring executives to hold shares. In certain instances, companies may require executives to hold a certain percentage of shares earned until share ownership requirements are satisfied. ISS's view of the latter policy is ambiguous. ISS's technical document on its QuickScore tool indicates that such a policy would not satisfy ISS's shareholding requirement. However, we have seen individual company's QuickScore reports that indicate ISS's shareholding requirement is met through such a policy. Hopefully, ISS will clarify this issue in its upcoming FAQ.

- **Burn rate**. Under ISS's prior policy, companies had some ability to develop grant practices that would likely satisfy applicable burn rate caps. However, the Policy Update provides no information as to the manner in which ISS will develop and apply burn rate caps going forward. Pending such guidance, it is not clear if companies will have the ability to ascertain whether their multiyear burn rate is likely to satisfy applicable burn rate caps.
- **Three other factors**. The Policy Update fails to indicate ISS's preferences with regard to minimum vesting standards applicable to CEO equity grants, the proportion of equity awards subject to performance conditions and the duration of an equity plan. Consequently, absent adequate guidance under ISS Compensation FAQ, companies will have no fundamental understanding as to what is required to meet these three factors.

Shareholder Proposals on Separating Role of CEO and Board Chair

ISS is implementing a more holistic policy for evaluating independent chair proposals.

Prior Policy

ISS's prior policy is generally to recommend FOR an independent chair shareholder proposal unless a 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 does not have any problematic governance or management issues, and
- The company has not 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 industry group, unless there has been a change in the CEO position within that time).

New Policy

ISS new policy modifies its prior policy in two respects:

- Changes the factors considered in evaluating an independent chair shareholder proposal, and
- Moves to a "holistic" review that weighs all the relevant factors (i.e., any single factor that may have previously resulted in a FOR or AGAINST recommendation may be mitigated by other positive or negative factors, respectively).

Under the new policy, ISS will generally recommend FOR shareholder proposals requiring the separation of the Board Chair and CEO roles, taking into consideration the following factors:

- The scope of the proposal (e.g., whether the proposal is binding or precatory, whether it is seeking an immediate change in the chair role or whether it is seeking to adopt a policy that may be implemented at the next CEO transition),
- The company's current board leadership structure (e.g., absence/presence of an executive chair),

- The company's governance structure and practices (e.g., director/CEO tenure),
- Company performance measured based on its one-, three- and five-year TSR compared to the company's peers and the market as a whole, and
- Any other relevant factors that may be applicable.

Additionally, the Policy Update notes that the following practices may result in ISS recommending FOR the shareholder proposal "absent a compelling rationale" for the maintenance of these practices:

- The presence of an executive or non-independent chair in addition to the CEO,
- A recent recombination of the role of CEO and chair, or
- The departure from a structure with an independent chair.

ISS 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.

Meridian comment. The Policy Update introduces significant subjectivity to ISS's evaluation of shareholder proposals on independent chairs that was not present under its prior policy. Due to this subjectivity, companies will find it difficult to determine their compliance with the new policy at the time of a shareholder proposal.

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The ***Client Update*** is prepared by Meridian Compensation Partners' Technical Team led by Donald Kalfen. Questions regarding this Client Update or executive compensation technical issues may be directed to Donald Kalfen at 847-235-3605 or dkalfen@meridiancp.com.