

## Practice Update

# ISS Releases Policy Updates for 2014 Proxy Season and Commences Consultation Period for Longer Term Policy Initiatives

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### Introduction

Institutional Shareholder Services Inc. (ISS) has released updates to its benchmark proxy voting guidelines for the 2014 proxy season. The updates, which are effective for meetings held on or after February 1, 2014, implement changes to ISS proxy voting policies relating to board responsiveness to shareholder proposals that receive the support of a majority of shares cast and modify ISS' quantitative pay-for-performance screen. The release also addresses shareholder proposals relating to lobbying activities and human rights risk assessments. Concurrently, ISS commenced a consultation and comment period for policy changes related to director tenure, director independence, independent chair shareholder proposals, and auditor ratification for periods after 2014.

ISS uses a company's self-selected peer group disclosed in its prior year proxy statement to construct an ISS peer group for purposes of certain voting recommendations. For the 2014 proxy season, ISS will take into account changes in a company's self-selected peer group subsequent to its 2013 proxy

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disclosures if such changes are **communicated to ISS by December 9, 2013**. The construction of the ISS peer group and the means for communicating changes in a company's self-selected peer group to ISS are described below.

## **Summary of the 2014 Policy Update**

### *Board Responsiveness*

A voting guideline announced last year provided that ISS would issue withhold recommendations for individual directors, committee members or the entire board of directors as appropriate if the board failed to act on a shareholder proposal that received the support of a majority of the shares cast, commencing in 2014 with respect to shareholder proposals receiving such support during

2013.<sup>1</sup> Under the 2014 voting guidelines, ISS will vote on a case-by-case basis if the board has failed to act on a shareholder proposal that received the support of a majority of the shares cast. This change reflects additional feedback received by ISS from surveys, roundtables, and public comments during 2013. ISS' 2013-2014 policy survey results reflected 40% institutional investor support for the ability of a board to freely exercise its discretion to respond to shareholder proposals in a manner believed to be in the best interests of the company while 36% of institutional investors indicated that the board should implement a shareholder proposal receiving majority support.

In cases where the shareholder proposal has not been fully implemented (or, if implementation requires a vote by shareholders, where a management proposal to implement the shareholder proposal is not placed on the next annual ballot), ISS will consider the following potential mitigating factors in making its vote recommendation:

- disclosed outreach efforts by the board to shareholders in the wake of the vote

- rationale provided in the proxy statement for the level of implementation
- the subject matter of the proposal
- the level of support for and opposition to the resolution in past meetings
- actions taken by the board in response to the majority vote and its engagement with shareholders
- the continuation of the underlying issue as a voting item on the ballot (as either shareholder or management proposals)
- other factors as appropriate

The 2014 policy revision added a disclosed board rationale as a mitigating factor.

### *Pay-for-Performance Screen*

ISS conducts a pay-for-performance analysis annually in making recommendations as to uncontested director elections. For companies in the Russell 3000 index, ISS considers alignment of total shareholder return (TSR) rank and CEO pay both in relation to an ISS-selected peer group and on an absolute basis. Prior to the 2014 policy revision, the ISS peer group evaluation took into account (i) relative degree of alignment (RDA) calculated as the difference between a company's TSR rank and its CEO's total pay rank within a peer group, as measured over one-year and three-year periods weighted 40% and 60%, respectively, and (ii) the multiple of the CEO's total pay relative to the peer group median.

The revised policy calculates RDA as a single, annualized measure for the three-year period (or shorter period if pay and performance data are not available for all three years). The purpose of this policy change was to, among other things:

- eliminate the overweighting of the most recent year's compensation that resulted from taking the

most recent year into account in calculating both the one-year and three-year components of RDA

- base recommendations on a better view of long-term pay and performance alignment that is less susceptible to distortion based on short-term volatility

Absolute alignment is measured as the alignment between the trend in the company's CEO pay and company TSR over the prior five fiscal years. As before, if the analysis of peer group alignment and absolute alignment demonstrates a significant unsatisfactory pay-for-performance alignment (or, in the case of a non-Russell 3000 company, where misaligned pay and performance are otherwise suggested), ISS may include in its pay-for-performance analysis specified qualitative factors to the extent relevant to an understanding of how compensation structure works to encourage or undermine long-term value creation and alignment with shareholder interests.

### *Lobbying Disclosure*

ISS has revised its policy relating to case-by-case consideration of shareholder proposals requesting information on a company's lobbying activities (direct, indirect and grassroots) to better articulate the factors ISS considers in its analysis. The revised policy takes into account participation in trade associations that engage in lobbying activities and enhances assessment of oversight mechanisms to include consideration of management oversight (in addition to board oversight).

### *Human Rights Risk Assessment Proposals*

ISS adopted a formal case-by-case voting policy for proposals requesting that a company conduct an assessment of human rights risks in its operations or in its supply chain or report on its human rights risk assessment process. ISS will take into account the extent to which the company's existing policies are disclosed; the company's industry and whether it

or its suppliers operate in countries or areas where there is a history of human rights concerns; involvement in recent controversies and remedial steps taken; and whether the proposal is overly burdensome or prescriptive.

## **Peer Group Modifications**

ISS bases a portion of its pay-for-performance analysis on a peer group constructed by ISS. The ISS peer group is based on the company's GICS industry classification, the GICS classifications of the company's disclosed benchmarking peers and size in terms of revenues (or assets in the case of certain financial companies) and market value. In selecting peers, ISS gives priority to companies that are within the subject company's self-selected peer group or that have chosen the subject company as a peer (so-called "first degree companies") and companies with numerous connections (by choosing as a peer or being chosen as a peer) with first-degree companies. The ISS methodology also gives priority to maintaining the subject company at or near the median of its peer group and maintaining approximately the distribution of GICS codes that is reflected in the company's self-selected peer group. There is no assurance that the company's self-selected peers will appear in the ISS peer group.

ISS has invited Russell 3000 companies with annual meeting dates between February 1, 2014 and September 15, 2014 to submit updates to their self-selected compensation benchmarking peers until 5:00 pm on December 9, 2013. ISS has established a web form to collect changes to company's benchmarking peer groups. The web form is available at [www.issgovernance.com/PeerFeedbackUS](http://www.issgovernance.com/PeerFeedbackUS). The updated peer group submission must be accompanied by a letter submission on the company's letterhead in a PDF format containing the full list of peers that were submitted online in accordance with further instructions to be generated by ISS.

Peer group submissions should be for the most recent fiscal year ended prior to the 2014 annual meeting. However, if a company anticipates making changes to its peer group for 2014, the updated peer group should be submitted to ISS to the extent the 2014 updates reflect business events such as mergers and spinoffs that make companies in the 2013 peer group no longer relevant. ISS expects that updated peer group information provided to it will match a company's benchmarking peer group information disclosed in its 2014 proxy statement and has indicated that it "may apply additional scrutiny" to any variance as part of its pay-for-performance analysis.

### **Consultation Period for Longer Term Policy Changes**

Concurrently with the release of its 2014 voting policy updates, ISS commenced a consultation and comment period to consider ISS' approach to certain policy issues for periods beyond 2014. The comment period on these potential policy changes will remain open until February 2014. The U.S. policies that are the subject of the consultation period are:

- *Director Tenure.* ISS is considering whether directors with lengthy tenure should be deemed non-independent and whether director tenure (or the mix of director tenures) should be taken into account in determining whether to issue a withhold recommendation for members of the nominating committee. ISS benchmark voting policies for the U.S. currently do not take director tenure into account.
- *Director Independence.* ISS classifies directors as inside directors, affiliated outside directors or independent outsiders based on specified criteria. ISS is considering adopting a more facts-and-circumstances based approach to independence determinations, in particular with respect to former CEOs, family relationships, and professional service providers.



- *Independent Chair Shareholder Proposals.* ISS generally recommends a vote “for” independent chair shareholder proposals unless the company maintains a counterbalancing governance structure, including a robust lead director position, and has no governance or performance concerns (with performance being measured as TSR performance relative to the company’s peers over one- and three-year periods). ISS is exploring as alternatives (i) always issuing “for” recommendations or (ii) recommending in favor of such proposals as a matter of best practice, subject to consideration of company-specific factors that may warrant a combined CEO/chair leadership structure.
  - *Auditor Ratification.* ISS is considering taking auditor tenure into account in determining whether to recommend a vote in favor of auditor ratification.
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<sup>1</sup> The prior ISS policy was to issue withhold recommendations based on a board failure to act where a shareholder proposal received the support of a majority of the shares outstanding in the previous year or the support of a majority of the shares cast in the last year and one of the two previous years.

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