

November 26, 2013

ISS Releases 2014 Voting Policies and  
Announces New Longer-Term Consultations

Institutional Shareholder Services Inc. (ISS) recently published its [2014 Corporate Governance Policy Updates](#), which would apply to annual meetings beginning in February 2014. ISS updated relatively few of its policies this year, but the changes largely represent a more measured, company-specific approach to corporate governance practices, which reflects a move by ISS to avoid “one-size-fits-all” policies and recommendations. ISS also announced a new consultation and comment period concerning potential policy changes applicable to the 2015 proxy season or beyond with respect to director tenure, director independence, independent chair shareholder proposals, equity-based compensation plans and auditor ratification.

**2014 Policy Updates**

Board Response to Majority Supported Shareholder Proposals. As [announced](#) last year, ISS evaluates a company’s response to shareholder proposals that receive a majority of shares cast in considering “withhold” recommendations against the full board, committee members or individual directors. With respect to such majority supported shareholder proposals, ISS will now make vote recommendations on director elections on a case-by-case basis and will no longer require boards to fully implement majority supported shareholder proposals in all cases. Instead, ISS will consider mitigating factors in cases involving less than full implementation, including the board’s articulated rationale for its response and level of implementation (with consideration of such rationales being a new factor not previously considered by ISS), disclosed shareholder outreach efforts by the board in the wake of the vote, the level of support and opposition for the proposal, actions taken, and the continuation of the underlying issue as a voting item on the ballot (as either shareholder or management proposals).

Beginning in 2014, ISS will also address case-by-case whether “withhold” recommendations are warranted in the following circumstances: where the board failed to act on a takeover offer into which a majority of shares tendered and where a director received more than 50% withhold/against votes of the shares cast at the last election and the company has not addressed the issue that caused the high withhold/against vote. Implementing an advisory vote on executive compensation on a less frequent basis than the frequency that received a plurality, but not a majority, of the votes cast at the most recent shareholder meeting at which shareholders voted on say-on-pay frequency will also result in a case-by-case review.

Pay-for-Performance Quantitative Screen. ISS has modified the methodology for calculating its Relative Degree of Alignment (RDA) pay-for-performance screen, a core component of its say-on-pay recommendation analysis. Currently, RDA is calculated by reference to the difference between a company’s TSR rank and the CEO’s total pay rank within an ISS-selected peer group, as measured over one-year and three-year periods (weighted 40% and 60%, respectively). Beginning with the 2014 proxy season, ISS will eliminate the one-year measurement period and calculate RDA solely by reference to relative TSR rank and CEO total pay rank over the three-year period.

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Lobbying. ISS has revised the factors it considers in evaluating shareholder proposals requesting details on a company's lobbying activities (direct, indirect and grassroots). Beginning in 2014, ISS will consider the company's current disclosure of relevant lobbying policies and oversight by the board as well as management, the company's disclosure regarding trade associations (a new ISS focus) or other groups that it supports (or is a member of) that engage in lobbying activities, and recent significant controversies, fines or litigation regarding the company's lobbying activities. ISS will no longer consider the impact that the public policy issues may have on the company's business operations, if specific issues are addressed in the proposal.

Human Rights Risk Assessment. Beginning in 2014, ISS will consider on a case-by-case basis proposals requesting that a company conduct an assessment of the human rights risks in its supply chain or operations or publish a report on its risk assessment process. In evaluating such proposals, ISS will consider the degree to which existing relevant policies and practices are disclosed (including as to actual implementation and oversight), the company's industry and whether the company or its suppliers operate in areas where there is a history of human rights concerns, the presence of recent, significant controversies, fines or litigation regarding human rights involving the company or its suppliers, and whether the proposal is unduly burdensome or overly prescriptive.

### **Consultation on Possible Longer-Term Voting Policy Changes for 2015 and Beyond**

Director Tenure. ISS is considering whether director tenure should be a factor in classifying directors as independent or determining vote recommendations on director elections, such as potential "withhold" votes against members of the nominating and governance committee. As ISS notes in its explanation for the new consultation, academic studies on this topic offer conflicting conclusions. We do not believe that there is a sufficient basis to consider an extended tenure of board service to be in and of itself indicative of a lack of director independence. Indeed, given the significant differences in companies' needs and directors' attributes and experiences, this is a clear instance where a company-specific approach is superior to a rigid rule.

Director Independence. ISS is considering whether to replace its bright-line distinctions for classifying a director as an inside director, an affiliated outside director or an independent outsider with a case-by-case analysis. Certain of the standards that ISS currently uses to classify directors are more stringent than those used by the Securities and Exchange Commission and national stock exchanges. In particular, ISS is considering taking into account facts and circumstances in assessing whether former CEO status, familial relationships, and professional services provided to the company should impact independence. We encourage ISS to adopt a case-by-case approach to classifying individual directors, rather than relying on inflexible standards.

Independent Chair Shareholder Proposals. Currently, ISS recommends a vote "for" independent chair shareholder proposals unless the company has a robust lead director position and has no other material governance or performance concerns. ISS is considering moving away from accommodating a strong lead director structure and instead always recommending a vote "for" independent chair proposals or, alternatively, generally recommending a vote "for"

independent chair proposals but considering certain company-specific circumstances, such as company size, the company's length of time as a public entity, and CEO transition, that may warrant a combined CEO/chair position. We believe that the current ISS policy, which permits a thorough review of a company's governance practices and recognizes that a robust lead director structure can provide effective leadership at boards with an executive chairperson, is superior to the proposed alternatives.

Equity-Based Compensation Plans. ISS's current policy can result in a recommendation against an equity compensation plan based on a failure of the plan to satisfy one of six tests enumerated by ISS. ISS is considering replacing this policy, which it describes as not taking into account mitigating factors, with a "balanced scorecard approach that allows the weighting of multiple factors in a holistic evaluation of the equity plan." We agree that all plan evaluations should be holistic, although any "scorecard" approach should avoid recommendations based solely on mechanical generic formulae and allow for appropriate exercise of judgment and flexibility to consider the situation of the particular company.

Auditor Ratification. ISS is considering whether to take into account the length of auditor tenure in determining the vote recommendation to ratify independent auditors. Currently, ISS recommends that shareholders vote to ratify auditors unless certain rare circumstances exist, such as if the auditor has a financial interest in the company or if fees for non-audit services are excessive. The interaction between an independent auditor and a company is an area of focus for regulators, national stock exchanges and industry participants, which are well-suited to evaluate appropriate requirements for sufficient auditor independence, and that audit committees can exercise appropriate discretion as to whether to require rotation based on company-specific circumstances. We believe that current regulations, in particular the legally mandated rotation of the lead audit partner every five years, and audit committee practices are appropriate.

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In contrast to policy changes in recent years, ISS' 2014 policy updates generally avoid a "one-size-fits-all" approach to corporate governance. However, the alternatives presented for consultation present a potential shift away from this more nuanced approach in certain important areas. We encourage companies to express their views of these potential changes to ISS. As always, we recommend that companies facing anticipated negative recommendations consider engaging with their shareholders and, if appropriate, with ISS in advance of the 2014 proxy season to ensure that all parties understand each company's unique business and governance situation.

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