ISS Releases Its 2014 U.S. Proxy Voting Summary Guidelines

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On January 13, 2014, Institutional Shareholder Services Inc. ("ISS") released its 2014 U.S. Proxy Voting Summary Guidelines (the "Guidelines"), outlining ISS's voting recommendations on management and shareholder proposals at publicly traded companies. While most of the recommendations therein are identical or substantially similar to those in last year's Guidelines, ISS has made several notable changes to its voting recommendations.

1. Four Fundamental Principles to Voting on Director Nominees in Uncontested Elections

In this year's Guidelines, ISS clarifies the four fundamental principles that apply in determining how to vote on director nominees in uncontested elections—board accountability, responsiveness, composition (which replaces "competence" in last year's Guidelines), and independence.

a. Accountability: ISS explains that boards must be "sufficiently accountable to shareholders, including through transparency of the company's governance practices and regular board elections, by the provision of sufficient information for shareholders to be able to assess directors and board composition, and through the ability of shareholders to remove directors." This description omits reference to shareholders' ability "to vote on takeover defenses or other charter/bylaw amendments," which was in last year's Guidelines, and adds the importance of keeping shareholders adequately informed.

b. Responsiveness: ISS's 2014 Guidelines indicate that "[d]irectors should respond to investor input, such as that expressed through significant opposition to management proposals, significant support for shareholder proposals (whether binding or non-binding), and tender offers where a majority of shares are tendered." The inclusion of shareholder expression through opposition to management proposals, as well as the parenthetical reference to both binding and non-binding shareholder proposals, are new to this year's Guidelines.

c. Composition: Replacing "competence" in last year's Guidelines, this principle requires companies to ensure that "directors add value to the board through their specific skills and expertise and by having sufficient time and commitment to serve effectively." In addition, as ISS adds this year, boards should be "of a size appropriate to accommodate diversity, expertise, and independence, while ensuring active and collaborative participation by all members."

d. Independence: In its 2014 Guidelines, ISS expands upon its view on board independence, recognizing the importance of board independence not only from management, but also from "significant shareholders," in order to ensure that boards "are able and motivated to effectively supervise management's performance for the benefit of all shareholders, including in setting and monitoring the execution of corporate strategy, with appropriate use of shareholder capital, and in setting and monitoring executive compensation programs that support that strategy."[1] Notably, ISS also adds this year that "[t]he chair of the board should ideally be an independent director, and all boards should have an independent leadership position or a similar role in order to help provide appropriate counterbalance to executive management, as well as having sufficiently independent committees that focus on key governance concerns such as audit, compensation, and nomination of directors."

2. Voting on Director Nominees in Uncontested Elections: Board Responsiveness

In this year's Guidelines, ISS amends its recommendation with regard to voting on director nominees in uncontested elections where the board's responsiveness to shareholder proposals is an issue. ISS's 2013 Guidelines indicated that ISS would recommend that shareholders vote against or withhold from individual directors, committee members, or the entire board if (1) for 2013, "the board failed to act on a shareholder proposal that received the support of a majority of the shares outstanding the previous year" or a majority of shares cast in the last year and one of the two previous years, or (2) for 2014, "the board failed to act on a shareholder proposal that received the support of a majority of the shares cast in the previous year." In a reversal, the 2014 Guidelines provide that ISS will evaluate director nominees on a case-by-case basis where the board's responsiveness is an issue. Moreover, the 2014 Guidelines implement a single threshold for the application of this new policy – the board's failure "to act on a shareholder proposal that received the support of a majority of the shares cast in the previous year." In particular, ISS now indicates that it will consider the following criteria in evaluating board responsiveness:

- 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); and
- Other factors as appropriate.

[1] This view differs from the independence standards articulated by the New York Stock Exchange, which focus solely on independence from management. *See* NYSE Rule 303A.02 and NYSE Commentary on Rule 303A.02.

Whereas last year's Guidelines relegate most of these factors to a footnote, this year's Guidelines elevate the factors to the text of the recommendation and include, as an additional factor for consideration, the board's rationale for the level of implementation.

ISS has explained that its policy change responds to feedback it received from investors and directors, who commented that "boards should either implement a governance action based on a majority supported shareholder proposal or provide a rationale for less than full implementation."[2] Thus, ISS has asserted that "directors should communicate how they made the determination that the response they chose is in the best interest of shareholders."[3]

3. Compensation: Executive Pay Evaluation

With regard to pay-for-performance evaluation, ISS states in its 2014 Guidelines, as it did last year, that it conducts an annual "pay-for-performance analysis to identify strong or satisfactory alignment between pay and performance over a sustained period," taking into consideration both peer group alignment and absolute alignment. In this year's Guidelines, however, ISS modifies its methodology for calculating one of the two measures it uses to determine peer group alignment. Historically, in determining peer group alignment, ISS has focused on "[t]he degree of alignment between the company's TSR rank and the CEO's total pay rank within a peer group, as measured over one-year and three-year periods (weighted 40/60)." As of this year, however, ISS considers "[t]he degree of alignment between the company's annualized TSR rank and the CEO's annualized total pay rank within a peer group, each measured over a three-year period."

Under the former method, because the calculation involved weighting the relative degree of alignment over a one-year period and over a three-year period, the most recent year was included in both measures and was, therefore, most heavily weighted. According to ISS, the new model weights each year of TSR equally and thus "does not over-emphasize any particular year during the measurement period."[4] Additionally, ISS believes that the new single-measure methodology will better reflect long-term pay and performance alignment (in part because the final year's performance will not dominate over the previous two years' performance) and thus aligns with ISS's "stated principles of evaluating long-term shareholder performance."[5]

4. Political Activities: Lobbying

In its 2014 Guidelines, ISS continues to recommend voting case-by-case with regard to proposals requesting information on a company's lobbying activities, policies, or procedures

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[2] *See* Institutional Shareholder Services Inc., U.S. Corporate Governance Policy, 2014 Updates (Nov. 21, 2013), at 6.

[3] *Id*.

[4] *Id*. at 8.

[5] *Id*. at 8-9.

but updates the factors that should be considered. ISS lists the following relevant factors for consideration:

- The company's current disclosure of relevant lobbying policies, and management and board oversight;
- The company's disclosure regarding trade associations 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-related activities.

The first factor, which referenced only "relevant policies and oversight mechanisms" in the 2013 Guidelines, now elucidates that the level of oversight provided by both the board and management should be considered. The second consideration, regarding disclosure of trade association activity, is entirely new to this year's Guidelines. Finally, the 2014 Guidelines omit from the list of factors "[t]he impact that the public policy issues in question may have on the company's business operations, if specific public policy issues are addressed."

5. Human Rights Proposals: Assessment of Human Rights Risks

In its new Guidelines, ISS formally adopts for the first time a policy with respect to "proposals requesting that a company conduct an assessment of the human rights risks in its operations or in its supply chain, or report on its human rights risk assessment process." ISS recommends voting case-by-case, considering the following factors:

- The degree to which existing relevant policies and practices are disclosed, including information on the implementation of these policies and any related oversight mechanisms;
- The company's industry and whether the company or its suppliers operate in countries or areas where there is a history of human rights concerns;
- Recent, significant controversies, fines, or litigation regarding human rights involving the company or its suppliers, and whether the company has taken remedial steps; and
- Whether the proposal is unduly burdensome or overly prescriptive.

This new addition to ISS's existing voting guidelines is a reaction to the submission of new proposals during the 2013 proxy season regarding a company's assessment of its risks related to human rights issues.[6] These proposals are distinct from the human rights proposals more frequently submitted in the past, "which have typically sought a report on a company's human

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[6] The number of human rights risk assessment proposals submitted last year was not significant; according to ISS, a total of fifteen resolutions in the general category of improving human rights standards or policies went to vote in U.S. public companies across all indexes in 2013, only a fraction of which were risk assessment proposals. *See* ISS Corporate Services, Governance Analytics, *available at* https://ga.isscorporateservices.com.

rights policies or the amendment of a company's human rights policies to bring them into greater conformity with international human rights standards and conventions."[7]

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If you have any questions or would like additional information, please do not hesitate to contact Yafit Cohn at (212) 455-3815 or yafit.cohn@stblaw.com, or any other member of the Firm's Public Company Advisory Practice.

[7] Institutional Shareholder Services Inc., U.S. Corporate Governance Policy, 2014 Updates, at 11.

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