



Georgeson Report

Expert advice on proxy voting and trends related to corporate governance



December 4, 2013

ISS Policy Updates for the 2014 Proxy Season

ISS Modifications Focus on Responsiveness of Companies to Majority Supported Shareholder Resolutions; Adjustment of Performance Metrics in Compensation Analysis

Institutional Shareholder Services (ISS) has issued its 2014 policy updates to its proxy voting guidelines. This year's modest changes to its guidelines become effective for shareholder meetings on or after February 1, 2014.

Responsiveness to Majority Votes on Shareholder Sponsored Resolutions, "Generally Vote Against" to "Case-by-Case"

Starting in 2014, ISS's policy on recommending withhold/against votes for directors who "failed" to adequately respond to a majority vote on a shareholder proposal will be triggered by a single majority of votes cast on the proposal (ISS previously recommended a withhold/against vote only after a single year of a majority vote of outstanding shares or two years of a majority of votes cast). In addition, ISS has issued a clarification that appears to give its analysts more discretion on whether to recommend withhold/against votes for directors after a majority support on a shareholder proposal. If the company response is partial – less than the full implementation of the successful resolution – the analyst now has the discretion to deem the board response as adequate on a case-by-case basis.

ISS also clarified that board responses to majority withhold/against votes on directors would be evaluated on a case-by-case basis. Therefore, the board rejection of a resignation could be deemed acceptable if the underlying reasons for the withhold/against vote are adequately addressed. A typical example would be removing a director deemed by ISS to be a potentially conflicted "affiliated outsider" from a key board committee (which prior to removal would have resulted in an ISS recommendation against the director and could have contributed to the majority withhold/against vote).

ISS also indicated it would consider on a case-by-case basis whether to recommend withhold/against votes for companies that conducted their "say-on pay" votes less frequently than the frequency supported by a plurality (but not a majority) of the votes cast on the say-on-pay frequency vote (the frequency vote takes place at least once every six years as mandated by The Dodd-Frank Wall Street Reform and Consumer Protection Act).

Finally, ISS will also consider on a case-by-case basis whether to recommend withhold/against votes for boards of companies that failed to accept a takeover where a majority of shareholders tendered their shares into the offer.

What Do These Changes Mean For You?

Response to shareholder proposals

For companies whose boards are subject to a potential withhold/against recommendations in 2014, there is an opportunity to consider what partial responses – those short of adopting the “black and white” letter of the majority supported resolution – will suffice to avoid a withhold/against recommendation that could result in a director resignation for those companies with majority voting or director resignation policies in place. Clues and precedents abound in ISS’s current proxy voting guidelines and past recommendations, so it makes sense to check with advisors to discuss not only how ISS may respond to a given partial response, but how your company’s institutional shareholders may vote on directors based on the response, regardless of whether the shareholders are ISS subscribers. In certain cases, as with proposals to declassify staggered boards, partial resolutions (other than phasing in annual elections) are unlikely to suffice, but other governance issues may have gray areas that allow for a creative bargain that satisfies ISS (as well as Glass Lewis, which considers recommendations for director withhold/against votes when proposals receive far less than a majority vote).

There are numerous issues to which the policy change could apply. An example of a potentially acceptable partial response to majority supported proposal would be a proposal to adopt the right of shareholders to act by written consent to remove directors or to amend various governing articles or bylaws. This is due to the fact that ISS already has in place a potential compromise policy that allows it to support company opposition to written consent proposals where a certain percentage of a company’s shareholders have the right to call special meetings to take such actions. Thus, the adoption of an adequate threshold to call special meetings may be an acceptable partial resolution in response to a majority-supported written consent proposal.

Another possible application of the changed policy could be in the case of a shareholder proposal asking for appointment of an independent Chairman. ISS currently considers existence of a lead independent director with certain prescribed duties as presenting a sufficiently countervailing structure to the combined CEO/Chairman role, causing ISS to recommend against the shareholder proposal to elect an independent Chairman. It will be interesting to see if ISS would consider adoption of such a lead independent director role as a potentially acceptable partial response in case of a shareholder supported independent Chair proposal.

Responses to takeover offers

In the realm of M&A and takeovers, the ISS proposal to consider withhold/against recommendations when boards fail to accept takeover offers that have received the tenders of a majority of shares is certainly of interest to targeted companies and practitioners in the M&A space. While it may seem obvious to some that an offer that receives a majority of shares outstanding has strong support, we at Georgeson have witnessed situations in which shareholders who believe the price is insufficient but have nonetheless supported offers to encourage the buyer not to withdraw its takeover efforts and to encourage the target board to negotiate. ISS generally does not render advice on whether investors should tender into an offer at a specific price, but potential targets should be aware that ISS will carefully consider the steps a board takes in responding to an overture: Has the board agreed to discuss the offer, has it offered reasonable due diligence, or has a special committee of the independent directors of the board been established to evaluate the current offer alongside other strategic alternatives? Additionally, the potential withhold/against vote recommendation as a result of a majority tender also puts ISS in the position of having to assess a target’s market value, an area that falls outside of its main area of expertise.

Frequency of Say-on-Pay votes

With respect to compensation, few companies fall in the category of holding say-on-pay votes less frequently than the plurality supported recommendation of the shareholders, and in fact a large majority of companies have selected annual say-on-pay votes in line with the policies of a large majority of institutional investors and the proxy advisory firms. Companies that hold say-on-pay votes less frequently than elected by a plurality of shareholders do so at their own peril.

Pay-for-Performance Metric Adjustment

Among the many metrics ISS utilizes to determine whether executive compensation is reasonably aligned with performance in determining its vote recommendation on say-on-pay proposals is total shareholder return (“TSR,” which is measured as stock price

appreciation plus dividends). An important part of the ISS quantitative analysis hinges on "Relative Degree of Alignment," or "RDA," which is determined by ranking TSRs and CEO pay versus peers on a one-year and three-year basis. The difference between the two rankings for TSR and pay combined for the one-year and three-year periods is used to determine the RDA score which is one of the primary factors in reaching an initial view of the say-on-pay vote (other quantitative and qualitative factors are also used to determine the final vote recommendation). This year's modification to the policy eliminates the one-year TSR and CEO pay to now solely use the three-year measurement period.

How Does This Affect You?

Eliminating the one-year measurements may favor companies where one year of compensation or stock price performance unduly weighs against a favorable score. On the other hand, companies that may have seen short-term TSR outperformance relative to peers or may have recently reduced their CEO pay may find their RDA score affected negatively under the revised methodology. While determining the true impact of the change is difficult, companies are advised to consult with their advisors or even ISS's consulting division to determine whether their scores and other executive compensation features – with respect to RDA and other quantitative and qualitative metrics – are likely to result in a positive recommendation. Companies with likely challenges with respect to the ISS recommendation on say-on-pay and on compensation issues generally should work with their advisors to develop investor communication strategies to maximize investor understanding of their challenges and how they are dealing with them, and thus their ultimate say-on-pay vote result.

Lobbying and Human Rights Assessment Disclosure Issues

Current ISS policy on shareholder proposals requesting information on lobbying activities considers several factors in determining whether to support the proposal:

1. the company's public disclosure of lobbying policies and oversight mechanisms currently in place;
2. any significant controversies, fines or litigation relative to the company's lobbying activities; and
3. the impact of public policy issues on a company's business operations if those issues are raised in the proposal.

In its policy update, ISS will now also consider a company's disclosure regarding trade associations that it supports or is a member of and the lobbying conducted by those organizations. It will also look for disclosure on management, in addition to board oversight mechanisms. Lastly, ISS eliminated the public policy issue factor claiming that the most recent versions of the shareholder proposal exclude this feature.

With respect to proposals requesting that a company conduct an assessment of human rights risk in a company's business operations, ISS has adopted a new guideline that somewhat follows the structure of the lobbying disclosure issue, focusing on current level of disclosure, oversight mechanisms, controversies, but adding a factor of whether the proposal is "unduly burdensome or overly prescriptive."

How Does This Affect You?

Proposals requesting lobbying information have recently been expanded to include the disclosure of company information regarding trade association dues and the percentage of such dues used for lobbying by such associations.

For those companies that receive such proposals, they should consider whether it is appropriate to add to or expand their existing disclosure, both in their proxy statements and on their corporate websites. With ISS and investors focused on the importance of meaningful oversight of such company activities, companies should consider whether to update their oversight policies to explain the involvement of both their boards and management in such oversight. If it turns out that providing completely thorough trade association disclosure would be unduly burdensome and costly (in compared to the benefits to the company and its investors), a company should consider thresholds (such as \$25,000 or \$50,000), below which they will not seek to obtain the requested information from their trade associations and clearly stating such thresholds in their disclosure.

With respect to the human rights risk policy, companies which operate in countries where

human rights policies are an issue may need to assess whether the current level of disclosure on human rights policy adequately addresses potential business risk issues, if any. It is possible that a brief disclosure reflecting the company's belief that such risks are not deemed material (if that is the case) may be sufficient to avoid ISS and shareholder support for the resolution. Engagement with proponents on this and other ESG issues can often result in withdrawal if properly conducted.

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