Hunton & Williams

Client Alert

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ISS Releases 2014 Updates to the US Corporate Governance Policy

Institutional Shareholder Services ("ISS") recently announced its updated voting policies for the 2014 proxy season. The policies will become effective for shareholder meetings held on or after February 1, 2014. We have summarized below four policy updates relating to corporate governance matters that may be of particular interest to US corporations.

Simplified Pay-for-Performance Executive Evaluation

ISS revised its policy relating to executive pay-for-performance evaluations. The ISS assessment uses a quantitative analysis called the Relative Degree of Alignment ("RDA") to identify alignment between executive pay and company performance. RDA measures the difference between the company's total shareholder return ("TSR") rank and the executive's total pay rank within his or her peer group over a period of time. Previously, ISS used a 40/60 weighted average of one-year and three-year RDA measures. For 2014, ISS will use an annualized RDA measure for the three-year measurement period. If a company has not been publicly traded for a period of three years, ISS will measure the TSR for the number of fiscal years available.

If the quantitative assessment signals an unsatisfactory evaluation of long-term shareholder performance, then ISS will look to qualitative factors including: (i) the ratio of performance-to-time-based equity awards; (ii) the ratio of performance-based compensation; and (iii) the company's peer group benchmarking practices to determine which compensation methods may work to best encourage long-term value creation for a case-by-case review of the pay-for-performance evaluation.

Board Responsiveness

For the 2014 proxy season, ISS will recommend that shareholders "withhold" or vote "against" individual directors, committee members or the entire board, as appropriate, on a case-by-case basis if the directors, members, or board:

- failed to act on a shareholder proposal that received support by a majority of shares cast in the prior year;
- failed to act on takeover offers where a majority of the shares were tendered; or
- failed to address an issue that caused a majority withhold/against vote for any director at the company's prior shareholder meeting.

ISS has stated that if a board does not fully adopt a proposal that is supported by a majority of the votes cast by shareholders, ISS will consider factors such as:

- the disclosed outreach efforts by the board to shareholders in the wake of the vote;
- the rationale provided in the proxy statement for the level of implementation;
- the level of support and opposition to the resolution in past shareholder meetings;
- actions taken by the board in response to the majority vote; and
- the continuing of the underlying issue as a voting item on the ballot.

Issuers will recall that in 2013, ISS changed its policy so that boards must be responsive to a proposal that garners support from a majority of the votes cast at the prior year's shareholder meeting rather than from a majority of the outstanding shares. In light of the 2014 policy changes, issuers will need to focus on shareholder outreach and proxy disclosure when deciding not to implement a shareholder proposal that received majority support. In addition, we believe disagreements are likely to increase between issuers and ISS with respect to whether a board had sufficiently implemented a shareholder-backed proposal.

The 2014 policies were also updated for reviewing the frequency of say-on-pay votes. ISS will now recommend on a case-by-case basis where the board:

- implemented an advisory vote on executive compensation on a less frequent basis than the frequency that received the majority of votes cast at the most recent shareholder meeting; or
- implemented 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, taking into account:
    - the board's rationale for selecting the frequency;
    - the company's ownership structure and vote results;
    - ISS's analysis of whether there are compensation concerns or historical compensation problems; and
    - the previous year's shareholder support on the executive compensation proposal.

Because most issuers have implemented an annual say-on-pay vote, this policy will apply to only a small number of companies.

Lobbying

ISS updated its policy regarding proposals requesting information on a company's lobbying activities to reflect more specifically the factors that ISS considers. The updated policy takes into consideration the company's: (i) disclosure of its lobbying policies and management's oversight of those activities; (ii) disclosure of groups that it supports or participates in that engage in lobbying activity; and (iii) recent disputes or fines regarding its lobbying-related activities.

Human Risk Assessment

ISS adopted a formal policy for proposals requesting that a company perform a human rights risk assessment or report on the existing process, if the company has implemented one. It will recommend a vote on a case-by-case basis after considering: (i) the degree of current disclosure of relevant policies; (ii) whether the company or its suppliers operate in countries that have a history of human rights concerns; (iii) recent disputes or fines regarding the company or its suppliers regarding human rights and whether the company has taken any corrective steps after the dispute; and (iv) whether the shareholder proposal is unduly burdensome or overly prescriptive.

Recent ISS Recommendation Involving Director Qualification Bylaws

Although not part of ISS's 2014 policy updates, ISS recently recommended "against" directors who adopted a bylaw prohibiting third-party compensatory arrangements between shareholders and director nominees. These bylaws have been adopted by several companies in recent months following two high-profile proxy contests in which hedge funds offered additional compensation to their director nominees based on the company's performance over specified time periods. As discussed in our client alert on the subject, these arrangements raise significant concerns over potential conflicts of interest.

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