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ISS Unveils 2014 Policy Updates and More

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ISS's recently announced 2014 policy changes for U.S. companies are relatively limited in scope compared to past years. The updates, which are largely unchanged from the draft policies released in November, will take effect for annual meetings beginning in February 2014.

More substantive policy revisions, however, are already in the works for the 2015 proxy season. ISS has opened a new consultation period through February 2014 to solicit feedback from governance stakeholders on five additional issues: independent chairman shareholder proposals, director tenure, director independence, auditor tenure, and equity plan scoring. Details of these and ISS's 2014 policy updates are presented below.

2014 Policy Updates

Board Responsiveness to Shareholder Proposals

Drawing the most criticism from the corporate community is ISS's decision, announced earlier this year, to recommend against the full board, individual directors, or specific committee members if the board fails to adequately respond to a shareholder proposal that was supported by a majority of votes cast in the prior year (calculated as the number of "for" votes as a percentage of "for" and "against" votes). In the past, ISS had applied a trigger of a majority of shares outstanding in the previous year or a majority of votes cast in two of the three prior years.

In making a "withhold" determination, ISS will take into account the following factors:

- The subject matter of the proposal.
- The level of support and opposition to the proposal.
- Disclosure in the proxy statement of outreach efforts between the company and shareholders following the vote.
- Actions taken by the board in response to the majority vote and the company's engagement with shareholders.
- The company's rationale for not fully implementing the shareholder proposal.
- The continuation of the underlying issue as a voting item (as either a shareholder or management proposal).
- Other factors.

Impact on issuers: Early annual meetings will shed more light on what ISS considers to be an acceptable response to any given type of shareholder proposal, short of full implementation. Clearly, a key determinant will be how well companies explain in their proxy statements the actions they have chosen to take based on feedback from their top holders. As indicated in Table 1, a number of companies have already moved forward in implementing shareholder resolutions that received majority support in 2013, particularly on widely accepted governance practices such as board declassification and majority voting.

Pay-for-Performance Evaluation

ISS has made one modification to its pay-for-performance (PFP) methodology used in evaluating management say-on-pay proposals.

ISS uses a two-prong quantitative test to determine PFP misalignment. Currently, relative alignment is measured by the company's total shareholder return (TSR) rank within a peer group against the CEO's total pay rank within a peer group over one- and three-year periods (weighted 40/60). Absolute alignment is measured by the trend in CEO pay against the trend in the company's TSR over the prior five fiscal years.

ISS is changing the measurement period in its relative alignment calculation from a 40/60 weighted average of one and three years to an annualized three-year period. ISS believes that weighting each year equally will provide a better view of long-term PFP alignment and diminish the impact of the timing of equity awards and periods of high volatility and mean reversion.

Impact on issuers: The change should be advantageous to issuers by de-emphasizing the latest year's pay and performance in ISS's calculations.

Human Rights Risk Assessment

ISS has created a new policy for shareholder proposals requesting companies to conduct an assessment of the human rights risks in their operations or supply chains or to report on their human rights risk assessment policies. These proposals were first introduced in 2013 by the American Federation of State, County and Municipal Employees (AFSCME) at Halliburton and McDonald's, and are likely to make a comeback in view of the strong voting support (39.5% and 34.6%, respectively).

ISS will take into account the following factors in its recommendations on these proposals:

- The company's disclosure of existing relevant policies and practices, including implementation and oversight,
- Whether the company or its suppliers operate in countries where there is a history of human rights abuses,
- Recent significant controversies, fines or litigation regarding human rights involving the company or its suppliers and any remedial steps taken, and
- Whether the proposal is unduly burdensome or overly prescriptive.

Impact on issuers: Targeting of these proposals will likely be limited to companies that have significant operations or suppliers in countries with a history of human rights abuses, particularly if there have been any related controversies. ISS supported the resolutions submitted at Halliburton and McDonald's in 2013.

Lobbying Disclosure

ISS has clarified its policy on shareholder proposals requesting disclosure of a company's lobbying activities, policies, or procedures to better reflect how ISS is actually evaluating the resolutions. The case-by-case approach will take into account the following factors:

- The company's current disclosure of its 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 surrounding the company's lobbying-related activities.

Impact on issuers: The update merely clarifies the factors ISS has been applying in making its recommendations on lobbying proposals and should not alter the extent it supports them. In 2013, ISS supported 75% of the resolutions and opposed 25%.

Dissident Compensation Bylaws

Although not included in the policy updates, ISS plans to issue additional guidance ahead of the 2014 proxy season on how it will react to corporate bylaws dealing with dissident compensation schemes.

According to ISS, some 33 companies have recently adopted bylaws that disqualify from board service any director candidates who receive compensation from a third party in connection with their candidacy or service on the board, other than existing employment agreements, indemnification, or out-of-pocket expenses. These are patterned after a model bylaw developed by Wachtell, Lipton, Rosen & Katz LLP following this year's proxy fights at Agrium and Hess, where the dissident candidates were offered sizable incentive bonuses by the hedge funds that nominated them. Wachtell argues that the bylaw protects companies from inappropriate director enrichment schemes, which can lead to fragmented and dysfunctional boards, conflicted and self-interested directors, and short-termist behavior.

ISS considers these types of bylaws to be overly broad, and recommended against the governance committee members at Provident Financial Holdings' Nov. 26, 2013 annual meeting for unilaterally adopting one. In its report, ISS maintained that the bylaw could exclude highly qualified candidates from board service and chill legitimate efforts by dissidents to seek board representation. Dissident nominees often receive a modest fee (typically $25,000-$50,000) for agreeing to stand for election and for the considerable time commitments they incur in a proxy fight. ISS contrasted the Wachtell bylaw to less onerous bylaw provisions adopted by some companies that bar nominees from board service only if they fail to disclose any third-party compensatory payments.

Impact on issuers: Companies that have adopted the Wachtell form of bylaw should refrain from making any revisions until ISS releases additional guidance. They should also solicit the views of their major shareholders on this issue, which could be at variance with ISS's position.

Beyond 2014

In a new initiative, ISS is inviting issuers, investors, and other governance stakeholders to weigh in on policy changes under consideration for 2015 and beyond. Comments are due by February 2014 (see http://www.issgovernance.com/benchmarkpolicyconsultation for further information). The topics under review are outlined below.

Independent Chairman

ISS is thinking of abandoning its longstanding policy on shareholder proposals calling for an independent chairman, which provides a carve-out for companies that have a combined chairman/CEO with a lead independent director. Because many companies have adopted this alternative leadership structure, ISS only supported half (52%) of this year's independent chairman proposals, compared to 75% in 2012.

ISS considers independent board chairs to be a best practice, but progress in this regard has been slow, particularly among large-cap companies.[1] Therefore, ISS is contemplating strengthening its policy in one of two ways:

- Supporting all independent chairman proposals, or
- Generally supporting the proposals except in specific cases, such as a newly public company or during a CEO transition.

Impact on issuers: ISS's proposed harder line approaches would encourage the proliferation of independent chairman proposals and potentially swing borderline votes to majority support. Moreover, ISS's suggested changes run contrary to the current sentiment of many investors: only six out of 62 independent chairman proposals received majority support in 2013, and only four out of 57 received majority support in 2012. Companies that have conducted outreach to top holders in response to majority votes, such as KeyCorp and Sempra Energy, found that most investors preferred enhancing the lead director's role to appointing an independent chairman.

[1] According to Spencer Stuart's 2013 Board Index, 45% of S&P 500 companies separate the chairman and CEO roles, but only 25% have a truly independent chair. See: https://www.spencerstuart.com/~/media/PDF%20Files/Research%20and%20Insight%20PDFs/SSBI-2013_01Nov2013.pdf

Director Tenure

ISS may adopt a policy on long-tenured directors with a view that lengthy board service could compromise a director's independence and objectivity. Following its fall roundtable discussions, ISS noted that although investor participants were hesitant to set strict limits on tenure, director participants were open to having a mechanism that could promote board diversity and board refreshment.

The change may consist of one of the following:

- Characterizing long-tenured directors as non-independent (affiliated outsiders). This would factor into ISS's evaluation of overall board and committee independence.

- Opposing the reelection of the nominating/governance committee members if average board tenure and/or individual director tenure exceeds a specified level.

Impact on issuers: Depending on ISS's threshold for lengthy board service, the proposed changes could result in a higher degree of "withhold" recommendations from individual directors or committee members.

Director Independence

ISS may alter its definition of director independence as it relates to former CEOs and familial and professional relationships.

- Currently ISS characterizes former CEOs as non-independent. ISS may ease this standard by applying a cooling off period or taking into account other factors.

- Currently ISS uses the SEC's definition of "immediate family member" in identifying significant familial relationships between the director and the company.2 ISS may broaden its definition to include other family members.

- Currently ISS uses a $10,000 materiality threshold for directors who provide professional services to their companies. ISS is considering a higher dollar threshold (such as the stock exchanges' $120,000 standard) or differentiating among types of services in determining the director's independence.

Impact on issuers: As a whole, the potential revisions would benefit companies by moving ISS's director independence criteria closer to those of the stock exchanges.

Auditor Tenure

ISS may take into account the audit firm's tenure in its recommendations on auditor ratification. This is in keeping with the view of some investors and regulatory bodies that excessive tenure may negatively impact the auditor's objectivity and audit quality.

Impact on issuers: Depending on where ISS sets the bar on over-tenured auditors, the proposed change could result in substantially more recommendations against auditor ratification. At a broader level, mandatory audit firm rotation was explored by the Public Company Accounting Oversight Board (PCAOB) in an August 2011 concept release, but is unlikely to move forward. In July 2013, the U.S. House of Representatives passed a bipartisan bill, the Audit Integrity and Job Protection Act (H.R. 1564), which would prohibit the PCAOB from requiring mandatory audit firm rotation for public companies. The bill still needs approval by the Senate.

[2] The SEC defines "immediate family" as spouses, parents, children, step-parents, step-children, siblings, in-laws, and any person (other than a tenant or employee) sharing the household.

Equity Plans

Currently, ISS recommends against equity plan proposals that contain any negative attributes, such as excessive cost (shareholder value transfer), a high burn rate, liberal change-in-control vesting provisions, no prohibition on repricing without shareholder approval, or pay-for-performance misalignment. ISS is considering a holistic approach whereby it would weigh negative attributes against positive features of the plan in making its ultimate vote recommendation.

Impact on issuers: The proposed change will be beneficial to issuers by evaluating the overall quality of equity plans and giving companies credit for shareholder-friendly features.

Conclusion

ISS's shift from a seasonal to year-round policy review process affords issuers more lead time to weigh in on and prepare for potential revisions. Because the proposed long-term policy changes have significant implications for companies, issuers should take the opportunity to provide comments by the February deadline. Companies should also monitor any conforming changes made to their major shareholders' voting policies and conduct outreach as needed. Alliance Advisors will keep clients apprised of any additional developments.

Table 1: 2013 Majority-Supported Shareholder Proposals

Target company	Proponent	Meeting Date	2013 Support Level[1]	Board Did Not Oppose Proposal	Past Majority Support	Implemented or Announced Plans to Implement in 2014
Declassify Board						
Airgas, Inc.	LACERA	August	58.3%		2012	
Air Products and Chemicals, Inc.	PRIM	January	80.6%			X
Ashland Inc.	PRIM	January	83.2%			X
BorgWarner Inc.	Nathan Cummings Foundation	April	98.9%	X		X
CareFusion Corp.[2]	LACERA	April	91.0%			X
Casella Waste Systems, Inc.	Bourgeon Partners, L.P.	October	57.9%			
Costco Wholesale Corp.	PRIM	January	72.2%			X
Foot Locker, Inc.	NCDST	May	91.4%			
Hospitality Properties Trust	CalPERS	May	90.6%		2012, 11, 10	
Huntsman Corp.	Florida SBA	May	61.9%			
Jacobs Engineering Group, Inc.	PRIM	January	82.4%			X
Jarden Corp.	NCDST	May	88.6%			
Kansas City Southern	James McRitchie	May	89.4%			
Kellogg Co.	NCDST	April	52.1%			
NCR Corp.	SBA	April	80.2%			
Netflix, Inc.	SBA	June	89.0%		2012	
PACCAR Inc.	NCDST	April	50.3%			
Rock-Tenn Co.	PRIM	February	86.2%			X
Rockwell Collins, Inc.	PRIM	February	92.4%	X		X
Royal Caribbean Cruises Ltd. (Liberia)	Robert L. Kurte and Harold Kurte	May	72.4%			
Sally Beauty Holdings, Inc.	PRIM	January	73.7%			X
SCANA Corp.	SERS	April	82.6%	X	2012	
Sirona Dental Systems, Inc.	PRIM	February	84.6%			
Teradata Corp.	NCDST	April	98.6%	X		X
Texas Roadhouse, Inc.	NYSCRF	May	83.3%			
TransDigm Group Inc.	PRIM	March	82.9%	X		
United States Steel Corp.	NCDST	April	82.1%		2012	
Varian Medical Systems, Inc.	PRIM	February	75.0%			
Vornado Realty Trust	ISBI	May	83.9%		2012, 11, 10	
WESCO International, Inc.	LACERA	May	88.1%			

Target Company	Proponent	Meeting Date	2013 Support Level[1]	Board Did Not Oppose Proposal	Past Majority Support	Implemented or Announced Plans to Implement in 2014
Majority Voting						
BB&T Corp.	Carpenters	April	52.6%		2011	
Devon Energy Corp.		June	51.4%			X
Duke Energy Corp.		May	50.1%			X
Hatteras Financial Corp.	CalPERS	May	67.6%			X
Healthcare Services Group, Inc.	CalSTRS	May	74.6%		2012	
Helmerich & Payne, Inc.	Carpenters	March	83.4%	X		X
Insperity, Inc.	CalSTRS	May	77.5%			X
ITC Holdings Corp.	CalSTRS	May	74.6%			
Koppers Holdings Inc.	CalSTRS	May	87.4%			
Mentor Graphics Corp.	CalSTRS	June	94.0%	X		
Met-Pro Corp.[3]	CalSTRS	June	71.4%			
Netflix, Inc.	CalSTRS	June	81.2%			
Red Lion Hotels Corp.	CalSTRS	May	95.6%	X		X
Rockwood Holdings, Inc.	CalSTRS	May	75.3%			X
Simpson Manufacturing Co., Inc.	CalSTRS	April	55.8%			X
Universal Health Realty Income Trust	CalSTRS	June	54.3%			X
Vornado Realty Trust	Carpenters	May	83.8%			
Proxy Access						
Advanced Photonix, Inc.[4]	Charles M. Knowles, Jr.	August	77.2%			
CenturyLink, Inc.	Assoc. of U.S. West Retirees	May	71.5%			
Darden Restaurants, Inc.	Nathan Cummings	Sept.	61.6%			
Nabors Industries Ltd.	New York City Pension Funds	June	51.0%		2012	
Verizon Communications, Inc.	Association of BellTel Retirees	May	53.2%			X
Poison Pill						
Ascent Capital Group, Inc.	GAMCO Asset Management	May	52.4%			
Supermajority Voting						
Aetna Inc.	John Chevedden	May	75.9%			
Ameriprise Financial, Inc.	John Chevedden	April	85.7%			
CareFusion Corp.[2]	Kenneth Steiner	April	74.3%			X
CF Industries Holdings, Inc.	John Chevedden	May	81.7%			
Chiquita Brands International Inc.	John Chevedden	May	85.4%			
Dover Corp.	John Chevedden	May	77.9%			
Hess Corp.	James McRitchie	May	83.9%			
Illinois Tool Works, Inc.	William Steiner	May	58.3%			
Netflix, Inc.	John Chevedden	June	81.1%			
PPG Industries, Inc.	John Chevedden	April	77.9%			
Public Service Enterprise Group Inc.	William Steiner	April	62.2%			
Quest Diagnostics Inc.	John Chevedden	May	88.8%	X		
Ryder System, Inc.	John Chevedden	May	60.8%			
Windstream Holdings, Inc.	Kenneth Steiner	May	53.2%			

Target Company	Proponent	Meeting Date	2013 Support Level[1]	Board Did Not Oppose Proposal	Past Majority Support	Implemented or Announced Plans to Implement in 2014
Special Meetings						
Edwards Lifesciences Corp.		May	70.5%			
Freeport McMoRan Copper & Gold[5]	CalSTRS	July	70.7%			X
Sunedison, Inc.		May	77.1%			
Xylem, Inc.	John Chevedden	May	57.2%			
Written Consent						
Allergan, Inc.	John Chevedden	April	50.2%			
Duke Energy Corp.		May	68.0%			
Occidental Petroleum Corp.	John Chevedden	May	53.5%			
Independent Chairman						
Freeport McMoRan Copper & Gold	AFSCME	July	56.6%			
Healthcare Services Group, Inc.	UAW	May	61.3%			
Kohl's Corp.	John Chevedden	May	51.5%			
Nabors Industries Ltd.	AFSCME	June	54.1%			
Netflix, Inc.	New York City Pension Funds	June	73.4%			
Vornado Realty Trust	Connecticut Retirement Plans	May	56.3%			

Target Company	Proponent	Meeting Date	2013 Support Level[1]	Board Did Not Oppose Proposal	Past Majority Support	Implemented or Announced Plans to Implement in 2014
Severance Pay						
Nabors Industries Ltd.	CalPERS	June	50.1%		2012	
Clawback Policy						
McKesson Corp.	Amalgamated Bank, UAW	July	52.9%			
Maximize Value						
Timken Co.	CalSTRS	May	53.4%			X
Animal Welfare						
Cracker Barrel Old Country Store, Inc.[6]	Humane Society	Nov.	96.2%	X		X
Board Diversity						
CF Industries Holdings, Inc.	New York City Pension Funds	May	50.7%			
Grassroots Lobbying						
Alliant Techsystems Inc.	Province of St. Joseph	July	64.8%			
Political Contributions						
CF Industries Holdings, Inc.	NYSCRF	May	66.0%			
Sustainability Report						
CF Industries Holdings, Inc.	Presbytarian Church	May	67.0%			
Miscellaneous						
AMERCO[7]		August	82.0%	X	2012, 11, 10, 09	X

Total majority votes	**89**
Number implemented or announced plans to implement in 2014	**25**

1. *Based on the number of "for" votes as a percentage of "for" and "against" votes.*
2. *Carefusion held its 2013 annual meeting in November. Shareholders approved management proposals to declassify the board and to reduce the supermajority threshold from 80% to 67%.*
3. *Met-Pro was acquired by CECO Environmental Corp. on Aug. 27, 2013. CECO Environmental has plurality voting.*
4. *The shareholder proposal at Advanced Photonix was a bylaw amendment, which did not receive the requisite support to pass.*
5. *The shareholder proposal at Freeport McMoRan Copper & Gold was a bylaw amendment, which was adopted on July 16, 2013.*
6. *The shareholder proposal at Cracker Barrel Old Country Store sought support for the company's decision to phase out pig gestation crates.*
7. *The shareholder proposal at AMERCO sought to ratify and affirm the board's decisions and actions for fiscal 2013.*

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