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ISS Publishes 2014 Draft Policy Changes; Comments Due by November 4, 2013

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On October 21, 2013, Institutional Shareholder Services Inc. (“ISS”) published its key draft policy changes for the 2014 proxy season (the “Draft Policies”). There are only two proposed updates for the US, neither of which represents sweeping reforms. The first modifies the existing pay-for-performance quantitative screen and the second clarifies ISS’s policy on board responsiveness to majority-supported shareholder proposals. The comment period closes on November 4, 2013, and ISS will publish comments as they are received. ISS’s final 2014 US and international policy updates are expected to be released during the week of November 18, 2013, and the final 2014 Global Policy Summary and Concise Guidelines are expected to be released in December. The 2014 policies will generally be effective for shareholder meetings of publicly-traded companies held on or after February 1, 2014.

Pay-for-Performance Quantitative Screen

Under its current policies, ISS uses two principal quantitative screens to identify companies where a potential pay-for-performance misalignment merits a deeper qualitative analysis of the pay program—absolute degree of alignment (“Absolute Alignment”) and relative degree of alignment (“RDA”). The Absolute Alignment screen measures alignment between CEO pay and company total shareholder return (“TSR”) over the prior five fiscal years. The RDA screen measures the degree of alignment between the company’s TSR and the CEO’s total pay, as compared against the company’s peers and as measured over one-year and three-year periods (weighted 40% and 60%, respectively).

For 2014, ISS proposes to simplify the methodology for calculating the RDA screen by limiting its review to a single three-year period (or any shorter period during which the company has disclosed pay data). ISS notes that a single three-year measure would provide a better view on long-term pay and performance alignment. Using a single three-year period will also diminish the effects of the timing of equity awards for companies that grant awards early in the fiscal year.

ISS is seeking specific comments on whether (1) there are circumstances under which performance or pay from the most recent year should weigh more heavily in a pay-for-performance analysis and (2) there are any unintended consequences from using an unweighted three-year pay and performance measure as the basis for the RDA screen.

Board Responsiveness to Majority-Supported Shareholder Proposals

In 2013, ISS made three significant changes to its policy on board responsiveness to majority-supported shareholder proposals:

- ISS will issue a negative vote recommendation for the board or individual directors if a board fails to act on a shareholder proposal that received the support of a majority of the shares cast in the previous year;¹
- ISS included additional guidance on the factors it will take into account in examining the sufficiency of the board's action in response to a majority-supported proposal; and
- ISS will apply a case-by-case judgment in determining which directors will be subject to a negative vote recommendation in the event that the level of responsiveness to a majority-supported proposal is found to be insufficient.

Under the 2013 policies, acting on a shareholder proposal means either full implementation of the proposal or, if the matter requires a vote by shareholders, a management proposal on the next annual ballot to implement the proposal. ISS will consider on a case-by-case basis responses that involve less than full implementation, taking into account: (1) the subject matter of the proposal; (2) the level of support and opposition provided to the resolution in past meetings; (3) disclosed outreach efforts by the board to shareholders in the wake of the vote; (4) actions taken by the board in response to its engagement with shareholders; (5) the continuation of the underlying issue as a voting item on the ballot (as either shareholder or management proposals); and (6) other factors as appropriate.

The change concerning the trigger for issuing a negative vote recommendation is being implemented on a transitional basis, and first become effective for the 2014 proxy season (relating to shareholder proposals that appeared on companies' ballots in 2013). The Draft Policies clarify that (1) recommendations on director elections will be made on a case-by-case basis and (2) ISS will explicitly consider the board's expressed rationale for acting or failing to act as disclosed in the proxy statement. No additional requirements are proposed to be implemented.

ISS noted that in 2013, it evaluated 84 majority-supported shareholder proposals and recommended withhold or against director nominees at five companies based solely on its then-existing board responsiveness policy. ISS expects to evaluate approximately 80 proposals in 2014. ISS is seeking specific comments as to (1) whether it should consider additional factors in evaluating directors if a board does not fully implement a majority-supported shareholder proposal and (2) what points the board should address in explaining its rationale to shareholders where a majority-supported proposal is not fully implemented.

¹ Under its prior policies, ISS would recommend that shareholders vote "against" or "withhold" their vote for the entire board of directors (other than new nominees who would be considered case-by-case) if the board failed to act on a shareholder proposal that either (1) received the support of a majority of the shares outstanding in the previous year, or (2) received the support of a majority of the shares cast in the prior year and one of the two previous years.

Conclusion

In contrast to the sweeping reforms to ISS's policies made in 2013, the Draft Policies merely clarify and modify existing policies. The modified RDA screen should not impose significant issues for a vast majority of companies. Given the upswing of compensation and corporate governance-related shareholder proposals in 2013, companies with shareholder proposals on their 2014 ballot should consider their response if these proposals gain majority support. The 2014 policies will generally be effective for shareholder meetings of publicly-traded companies held on or after February 1, 2014.

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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