



An MSCI Brand

European Corporate Governance Policy

2012 Updates

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Institutional Shareholder Services Inc.

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ISS' European Corporate Governance Policy 2012 Updates

Effective for Meetings on or after Feb. 1, 2012
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These policy updates present changes and clarifications to ISS' European benchmark guidelines for 2012. If new issues arise, such as shareholder proposals or regulatory developments, prior to the next formal update, ISS will adopt policies to cover such issues on an as-needed basis. Note that markets covered in this updates document exclude Eastern Europe. The voting policy applied by ISS in the U.K. is that of the National Association of Pension Funds (NAPF) and an update to that policy document will be issued by the NAPF.

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INTRODUCTION

The primary purpose of a public corporation is to create sustainable value for its shareowners. To that end, ISS designs its proxy voting guidelines to enhance shareholders' long-term economic interests. ISS' Benchmark proxy voting guidelines serve as a tool to assist institutional investors in meeting their fiduciary requirements with respect to voting by promoting shareholder value creation and risk mitigation at their portfolio firms.

ISS reviews and updates its proxy voting guidelines each year, taking into account emerging issues and trends, the evolution of market standards, regulatory changes, and feedback provided by ISS' institutional clients.

ISS' robust and transparent [policy formulation process](#) includes an exhaustive review of relevant empirical studies and other factual data, an annual [policy survey](#) of institutional clients and corporate issuers, policy roundtables with a wide range of industry constituents, and an open [comment period](#) on draft policy changes. ISS also conducts internal research to validate assumptions and policy positions.

The Benchmark Policy Guidelines consider market-specific recommended best practices, transparency, and disclosure when addressing issues such as board structure, director accountability, corporate governance standards, executive compensation, shareholder rights, corporate transactions, and social/environmental issues.

ISS' policy guidelines require the consideration of company-specific circumstances. When issuing a vote recommendation on a proposal, ISS considers historical operating and investment performance, company disclosure (and proponent/dissident disclosure, if applicable), the company's governance structure and historical practices, and its industry.

In applying these policies, ISS often engages with public issuers, shareholders, activists, and other stakeholders to seek additional information and to gain insight and context in order to provide our clients with informed vote recommendations. This engagement process enhances dialogue and promotes a higher level of understanding between investors and the companies in which they invest.

In formulating proxy voting policies, ISS assesses the potential costs and benefits of the adoption or rejection of the underlying ballot items. Where the economic impact of a ballot item is not apparent and may involve trade-offs, the guidelines direct analysts to consider the economic consequences as well as potential risks to shareholders of approval.

This document presents the changes being made to ISS' Benchmark European Corporate Governance Policies. The document, along with other policy documents, is available on our Web site under the [Policy Gateway](#). If you have any questions, please contact ISS_EU-research@issgovernance.com.

These policy changes will be effective for meetings on or after Feb. 1, 2012.



BOARD

Corporate Governance Issue: Voting on Director Nominees in Uncontested Elections

Board Accountability – Governance Failures

Current Recommendation: Under extraordinary circumstances, vote AGAINST or WITHHOLD from directors individually, committee members, or the entire board, due to:

- Material failures of governance, stewardship, or fiduciary responsibilities at the company;
- Failure to replace management as appropriate; or
- Egregious actions related to the director(s)' service on other boards that raise substantial doubt about his or her ability to effectively oversee management and serve the best interests of shareholders at any company.

Key Change: Adding an explicit reference to risk oversight.

New Recommendation: Under extraordinary circumstances, vote AGAINST or WITHHOLD from individual directors, members of a committee, or the entire board, due to:

- Material failures of governance, stewardship, risk oversight, or fiduciary responsibilities at the company;
- Failure to replace management as appropriate; or
- Egregious actions related to a director's service on other boards that raise substantial doubt about his or her ability to effectively oversee management and serve the best interests of shareholders at any company.

Rationale for Update: This policy update clarifies ISS' existing policy by highlighting the significance of risk oversight within the broader concept of directors' fiduciary responsibilities. The intention of this update is not to penalize boards for taking prudent business risks or for exhibiting reasonable risk appetite, but is instead intended to address situations where there has been a material failure in a board's role in overseeing the company's risk management practices.

Over the past few years, the market has seen a multitude of well-publicized failures of board risk oversight. These failures are not limited to the financial sector, as evidenced by the events leading up to the Deepwater Horizon oil spill of 2010, or the scandals surrounding News Corporation's U.K. operations in 2011. The importance of proper risk oversight has been further highlighted by a number of national and international codes of best practice, including, but not necessarily limited to, the International Corporate Governance Network's TCRO guidelines, and the Council of Institutional Investors' Corporate Governance Policies.



Classification of Directors: Board Tenure

Current Recommendation: [When determining whether a director is classified as non-independent], years of service is generally not a determining factor unless it is recommended best practice in a market and/or in extreme circumstances, in which case it may be considered.

For example, in continental Europe, directors with tenure exceeding 12 years will be considered non-independent. In the United Kingdom and Ireland, directors with tenure exceeding nine years will be considered non-independent, unless the company provides sufficient and clear justification that the director is independent despite his long tenure.

Key Changes:

- Clarify that director tenure is a criterion for non-independence as a rule, not as an exception, under the European policy.
- Updated policy makes specific reference to the basis for the 12-year tenure guideline – the European Commission (EC) Recommendation 2005/162/EC
- Clarify that tenure is measured from the date of first appointment and clarify that a shorter tenure period will be used for markets where this is either practice or recommended best practice.

New Recommendation: Excessive years of service from date of first appointment, as determined by the EC Recommendation 2005/162/EC, local corporate governance codes, or local best practice, is generally a determining factor in evaluating director independence.

For example, the EC recommendation 2005/162/EC's definition of independence provides that in order to remain independent, a non-executive director shall have served on the [supervisory] board for no more than 12 years. For countries governed by ISS' European policy, ISS will follow the EC recommendation and apply stricter tenure limits where recommended by local corporate governance codes or established by local best practice.

Rationale for Update: The updated policy is in line with current policy application and clarifies that the 12-year limit was selected in line with the EU Recommendation of 2005.



Directors Term Lengths in Excess of Four Years

Current Recommendation: *For Belgium, Denmark, Finland, Italy, Netherlands, Norway, Sweden, and Switzerland, vote AGAINST the election or (re)election of any director when the term is not disclosed or when it exceeds four years and adequate explanation for noncompliance has not been provided.*

For France and Spain, generally vote AGAINST the (re)election of any director (except for the CEO) who will serve for a term exceeding four years. However, in determining vote recommendations on the (re)election of directors, the following additional factors will be taken into account on a CASE-BY-CASE basis:

- Composition of the board and its committees (e.g., independence as defined by ISS criteria);
- Board functioning (attendance, evaluation);
- Company disclosure on internal rules and/or a resignation schedule to organize staggered (re)elections of the board members in order to avoid too many reappointments coming up for simultaneous review; and
- The company's overall governance practices.

Vote AGAINST article amendment proposals seeking extensions of director terms. In cases where a company's articles provide for a shorter limit, and where such a company wishes to extend a director term from three to four years, for example, vote AGAINST based on the general principle that director accountability is maximized by elections with a short period of renewal.

Key Changes: France will be removed from the carve-out and added to the standard policy text. Note that Spain will remain in the carve-out.

New Recommendation: *For Belgium, Denmark, France, Finland, Italy, Netherlands, Norway, Sweden, and Switzerland, vote AGAINST the election or (re)election of any director when the term is not disclosed or when it exceeds four years and adequate explanation for noncompliance has not been provided.*

For Spain, generally vote AGAINST the (re)election of any director (except for the CEO) who will serve for a term exceeding four years. However, in determining vote recommendations on the (re)election of directors, the following additional factors will be taken into account on a CASE-BY-CASE basis:

- Composition of the board and its committees (e.g. independence as defined by ISS criteria);
- Board functioning (attendance, evaluation);
- Company disclosure on internal rules and/or a resignation schedule to organize staggered (re)elections of the board members in order to avoid too many reappointments coming up for simultaneous review; and
- The company's overall governance practices.

Vote AGAINST article amendment proposals seeking extensions of director terms. In cases where a company's articles provide for a shorter limit, and where such a company wishes to extend a director term from three to four years, for example, vote AGAINST based on the general principle that director accountability is maximized by elections with a short period of renewal.

Rationale for Update: In France, the maximum duration of directors' terms authorized by law is six years. Nonetheless, according to the 2008 AFEP-MEDEF recommendations, the duration of directors' terms of office, set by the bylaws, should not exceed a maximum of four years. The Middelnext code (the corporate governance code for French small- and mid-cap companies) does not recommend a specific maximum but encourages companies to avoid a lengthy duration of mandates.

Regarding the French market, many companies (even in mid- and small-cap indexes) tend to align with the maximum of four years. Few companies of the large- and mid-caps index maintain directors' terms in excess of four years. In practice, director terms exceeding four years is common especially in very small-cap companies, but in these companies the level of disclosure is generally poor such that shareholders cannot fully assess the quality of their governance practices. In 2010, ISS strengthened its policy by recommending a vote AGAINST article amendment proposals seeking extensions of director terms. Thus, the policy update to apply the standard policy to the French market also provides a stronger alignment to the ISS policy regarding article amendments seeking extension of director terms.



Censors (France)

Current Recommendation: No policy on the (re)election of censors (i.e., non-voting board members).

Key Changes:

- Adopt new policy to generally recommend AGAINST the (re)election of censors, bylaws amendments to authorize the appointment of censors, or to extend the maximum number of censors to the board.
- However, vote CASE-BY-CASE when the company provides assurance that the censor will serve on a short-term basis (maximum one year) with the intent to retain the candidate before his/her election as director at the next AGM.
- To better assess overboarding situations when the elections of directors/supervisory board members are on the agenda, the nominee's outside mandates as censors in public companies will now be taken into account for director elections.

New Recommendation:

Election of censors (France)

For *widely held companies*, generally vote AGAINST proposals seeking shareholder approval to elect a censor, to amend bylaws to authorize the appointment of censors, or to extend the maximum number of censors to the board.

However, vote on a CASE-BY-CASE basis when the company provides assurance that the censor would serve on a short-term basis (maximum one year) with the intent to retain the nominee before his/her election as director. In this case, consideration shall also be given to the nominee's situation (notably overboarding or other factors of concern).

In consideration of the principle that censors should be appointed on a short-term basis, vote AGAINST any proposal to renew the term of a censor or to extend the statutory term of censors.

Overboarded directors (Europe)

New Provision:

For directors standing for (re)election at French companies, take into account board appointments as censors in French publicly listed companies.

Rationale for Update: In France, certain boards of directors include "censors," which are essentially advisers to the board without voting rights. Censors are not defined under French law and bear no legal liability toward shareholders, and their duties are oftentimes not clearly disclosed and may vary from company to company. Despite a lack of voting rights or any legally defined responsibilities, censors oftentimes receive remuneration on par with that of the company's non-executive directors, and because in practice many are ex-directors or senior executives, their influence on the board may be considerable.

There is concern that companies have started to classify persons as censors in order to circumvent certain conventions of good governance, thereby allowing the company to comply with "the letter of the code" if not the spirit. For example, reclassifying a non-independent or overboarded director as a censor may allow a company to comply with best practice recommendations on board independence or overboarding. In addition, consulting services provided by censors are not subject to shareholder approval as a related-party transaction, whereas analogous services provided by directors are subject to shareholder approval. ISS has observed concrete examples in the French market that have given rise to these concerns, whereas in other markets where similar advisory positions exist (such as in Italy or Japan – both countries where the role has legally defined responsibilities), such instances have not been observed.

The policy change will address such concerns with respect to the French market and change ISS' policy approach on items relating to the election of censors, from "generally recommend FOR" (given the lack of a specific policy position on censors) to "generally recommend AGAINST." This policy approach is supported by the majority of institutional respondents to ISS' 2011-2012 Policy Survey: a combined 64 percent indicated that the nomination of a censor or modification of company bylaws in order to set up the role of a censor is either never appropriate (32 percent) or appropriate if the appointment is temporary (32 percent). During ISS' 2011-2012 Comment Period, there was a consensus among commenters that ISS should take a restrictive approach to the nomination of censors, meaning that support for the nomination of censors is only acceptable in extraordinary circumstances or if the censor mandate is temporary. There was also agreement that the shift of a director to a censor position is never acceptable if done to circumvent good governance practices.



COMPENSATION

Corporate Governance Issue: Voting on Equity-based compensation plans

Equity-based compensation (France)

Current Recommendation: Generally vote FOR equity-based compensation proposals for employees if the plan(s) are in line with long-term shareholder interests and align the award with shareholder value. This assessment includes, but is not limited to, the following factors:

- The volume of awards transferred to participants must not be excessive: the potential volume of fully diluted issued share capital from equity-based compensation plans must not exceed the following ISS guidelines:
 - The shares reserved for all share plans may not exceed 5 percent of a company's issued share capital, except in the case of high-growth companies or particularly well-designed plans, in which case we allow dilution of between 5 and 10 percent: in this case, we will need to have performance conditions attached to the plans which should be acceptable under ISS criteria (challenging criteria);
- The plan(s) must be sufficiently long-term in nature/structure: the minimum vesting period must be no less than three years from date of grant;
- The awards must be granted at market price. Discounts, if any, must be mitigated by performance criteria or other features that justify such discount.

If applicable, performance standards must be fully disclosed, quantified, and long-term, with relative performance measures preferred.

Key Change: A carve-out policy will be introduced for French companies on certain provisions of the equity-compensation guidelines, including the following changes:

- Increased focus on performance criteria in line with local best practice: For companies that refer to the AFEP-MEDEF Code, ISS will expect that all awards granted to executives will be subject to challenging performance criteria or premium pricing. For companies that refer to the Middlenext Code or no code at all, ISS will expect at least a portion of awards to executives to be subject to challenging performance criteria or premium pricing. In all cases, free shares shall remain subject to performance criteria for all beneficiaries.
- Increase on the allowable volume of capital that could be reserved for equity plans, to 10 percent of share capital for all companies.
- Introduction of a burn rate criterion to measure use of capital.

New Recommendation:

Generally vote FOR equity-based compensation proposals for employees if the plan(s) are in line with long-term shareholder interests and align the award with shareholder value. This assessment includes, but is not limited to, the following factors:

- The volume of awards transferred to participants must not be excessive: the potential volume of fully diluted issued share capital from equity-based compensation plans must not exceed the following ISS guidelines:
 - The shares reserved for all share plans may not exceed 5 percent of a company's issued share capital, except in the case of high-growth companies or particularly well-designed plans, in which case we allow dilution of between 5 and 10 percent: in this case, we will need to have performance conditions attached to the plans which should be acceptable under ISS criteria (challenging criteria)*;
- The plan(s) must be sufficiently long-term in nature/structure: the minimum vesting period must be no less than three years from date of grant; and

- The awards must be granted at market price. Discounts, if any, must be mitigated by performance criteria or other features that justify such discount.

If applicable, performance standards must be fully disclosed, quantified, and long-term, with relative performance measures preferred.

* Market-specific provisions for France:

- The potential volume from equity-based compensation plans must not exceed 10 percent of fully diluted issued share capital.
- In addition, for companies that refer to the AFEP-MEDEF Code, all awards (including stock options and warrants) to executives shall be conditional upon challenging performance criteria or premium pricing. For companies referring to the Middlednext Code (or not referring to any code) at least part of the awards to executives shall be conditional upon performance criteria or premium pricing. In both cases, free shares shall remain subject to performance criteria for all beneficiaries.
- Finally, for large- and mid-cap companies, the company's average three year unadjusted burn rate (or, if lower, on the maximum volume per year implied by the proposal made at the general meeting) must not exceed the mean plus one standard deviation of its sector but no more than one percentage point from the prior year sector cap.

Rationale for Update: The introduction of stricter expectations on performance criteria in France brings ISS policy into line with local best practice recommendations, and the increased focus on performance criteria reflects investor views. We further note that the introduction of the burn rate criterion will provide focus on the actual transfer of equity to employees. ISS already applies similar burn rate policies for other markets (such as the U.S., Canada, and in the ABI guidelines for the U.K.), and 58 percent of institutional respondents to the 2011-2012 Policy Survey supported the inclusion of burn rate criteria in the equity compensation policy. Other provisions of the ISS European Compensation Guidelines (including vesting periods, administration body, and so forth) will continue to apply to French companies.

During ISS' 2011-2012 Comment Period, there was a consensus among institutional shareholder respondents in support of the policy amendments. Respondents agreed that ISS should consider all members of the executive committee, and not just corporate officers, as "executives" for the purpose of policy application, and that ISS should expect all equity-based compensation for corporate officers to contain performance criteria regardless of the governance code to which the company refers. With respect to companies following the Middlednext Code, there was no consensus among commenters on an exact percentage of equity awards that should contain performance criteria. There was also disagreement on the approach ISS should take if the company fails to disclose performance targets on a prospective basis. While there was agreement that a company's past track record of target-setting should be taken into account, some institutional shareholders stated that an equity plan should only be accepted if the company's disclosure materially demonstrates that future awards will have challenging performance targets. Others indicated that if the company has a positive track record of setting challenging performance targets, this could mitigate their concerns about a lack of disclosure of future targets.

The burn rate table for France will be included in the 2012 European Policy Summary, which will be published in December 2011. In December, ISS will also publish a document providing answers to frequently asked questions on the definitions and methods used for this new policy, as well as on certain application points.



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