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European Corporate Governance Policy

2014 Updates

November 21, 2013

Institutional Shareholder Services Inc.

ISS' European Corporate Governance Policy
2014 Updates

Effective for Meetings on or after Feb. 1, 2014
Updated Nov. 21, 2013

These policy updates present changes and clarifications to ISS' European benchmark guidelines for 2014. 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.

Currently, the European Corporate Governance Policy (hereafter "European Policy") is applied to companies incorporated in the following territories: Austria, Belgium, Cyprus, Denmark, the Faroe Islands, Finland, France, Germany, Greece, Greenland, Iceland, Italy, Liechtenstein, Luxembourg, Malta, the Netherlands, Norway, Portugal, Spain, Sweden, and Switzerland.

From February 2014, the European Policy will also be applied to companies in the following territories: Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia. The inclusion of these new markets under the European Policy is based on the fact that these EU Member States are subject to the same European Commission directives as most of the markets currently covered under the European policy. However, as is the case for the policy's current coverage, individual policy provisions may either exclude certain markets or limit themselves to a subset of markets, based on different market practices and best practice recommendations throughout Europe.

The voting policy applied by ISS in the U.K. and Ireland 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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SUMMARY OF ISS' POLICY FORMULATION PROCESS

Each year, ISS' Global Policy Board conducts a robust, inclusive, and transparent global policy formulation process that produces the benchmark proxy voting guidelines that will be used during the upcoming year.

The policy review and update process begins with an internal review of emerging issues and notable trends across global markets. Based on data gathered throughout the year (particularly from client and issuer feedback), ISS forms policy committees by governance topics and markets. As part of this process, the policy team examines academic literature, other empirical research, and relevant commentary. ISS also conducts surveys, convenes roundtable discussions, and posts draft policies for review and comment. Based on this broad input, ISS' Global Policy Board reviews and approves final drafts and policy updates for the following proxy year. Annual updated policies are announced in November and apply to meetings held on and after February 1 of the following year.

Also, as part of the process, ISS collaborates with clients with customized approaches to proxy voting. ISS helps these clients develop and implement policies based on their organizations' specific mandates and requirements. In addition to the ISS regional benchmark (standard research) policies, ISS' research analysts apply more than 400 specific policies, including specialty policies for Socially Responsible Investors, Taft-Hartley funds and managers, and Public Employee Pension Funds, as well as hundreds of fully customized policies that reflect clients' unique corporate governance philosophies. The vote recommendations issued under these policies often differ from those issued under the ISS benchmark policies. ISS estimates that the majority of shares that are voted by ISS' clients fall under ISS' custom or specialty recommendations.

Key Strengths of ISS' Policy Formulation Process

Industry-Leading Transparency: ISS promotes openness and transparency in the formulation of its proxy voting policies and the application of these policies in all global markets. A description of the policy formulation and application process, including specific guidelines and Frequently Asked Questions, appear on our website under the Policy Gateway section.

Robust Engagement Process with Industry Participants: Listening to diverse viewpoints is critical to an effective policy formulation and application process. ISS' analysts routinely interact with company representatives, institutional investors, shareholder proposal proponents, and other parties to gain deeper insight into critical issues. This ongoing dialogue enriches our analysis and informs our recommendations to clients.

Global Expertise: ISS ' policy formulation process is rooted in global expertise. ISS' network of global offices provides access to regional and local market experts for the Americas, EMEA (Europe/Middle East/Africa), and Asia-Pacific regions.

This document presents the changes being made to ISS' Benchmark European Corporate Governance Policies. The full text of the updates, detailed results from the Policy Survey, and comments received during the open comment period, are all available on ISS' website under the Policy Gateway.

The ISS 2014 European Policy Updates included here will be effective for meetings on or after February 1, 2014. In December 2013, ISS will release a complete set of updated policies (in full or summary form). For other updates, please refer to the Executive Summary of Key 2014 Updates and Process.

If you have any questions, please contact ISS_EU-research@issgovernance.com.

BOARD

Corporate Governance Issue:
Voting on Director Nominees in Uncontested Elections

Board Independence (Europe)

Key Changes: ISS is making several amendments to its European policy concerning board independence. These changes specifically relate to the treatment of companies with controlling shareholders, as well as widely held companies in Greece and Hungary. A full version of the revised board independence policy will be available in the European Proxy Voting Summary Guidelines in December 2014. Detailed explanations of the specific changes to the board independence policy can be found below under the sections titled "Board Independence at Controlled Companies (Europe)", "Board Independence (Greece)", and "Board Independence (Hungary)".

Board Independence at Controlled Companies (Europe)

Current Recommendation: For companies that are either family-controlled or have a majority shareholder, ISS applies an independence rule that is proportionate to the economic interest of the controlling family or majority shareholder. Controlled company is defined based on economic interest and not voting power.

Key Changes:

- Create a comprehensive policy for evaluating board independence at controlled companies, and add a one-third minimum board independence threshold;
- Amend the wording of the policy as clarification;
- Remove the reference to family controlled companies; and
- Add a carve-out for markets where the local corporate governance code makes a recommendation concerning board independence at controlled companies.

New Recommendation: For companies with a majority shareholder, generally vote against the election or reelection of any non-independent directors (excluding the CEO) if the level of independence on the board will be lower than minority shareholders' percentage of equity ownership, or if the board will be less than one-third independent (whichever is higher).

Minority shareholders' ownership percentage is calculated by subtracting the majority shareholder's equity ownership percentage from 100 percent. Majority control is defined in terms of economic interest and not voting rights, and is considered to be any shareholder or group of shareholders acting collectively that control at least 50 percent + 1 share of the company's equity capital.

This independence threshold is applied to controlled widely held companies or main index-listed/MSCI-EAFE member companies which would otherwise fall under a 50-percent independence guideline as described in the Board Independence Policy.

Carve Out: In markets where the local corporate governance code addresses board independence at controlled companies, ISS will generally recommend against the election or reelection of any non-independent directors (excluding the CEO) if the level of independence on the board is lower than the local code recommendation, but in any case if the level of board independence is below one-third.

This policy is not applied for Italy and Portugal.

Rationale for Update: For companies that are controlled by a single shareholder or group of shareholders acting collectively, potential conflicts with the majority owner and possible abuse of minority shareholder rights represent significant governance risks. It is therefore important that shareholders who invest in controlled companies are provided with adequate protection at the board level.

ISS' current independence guideline for controlled companies in Europe is based on the majority shareholder's equity ownership stake. Under the new comprehensive policy, ISS will generally recommend against non-independent directors if the level of independence on the board is less than the inverse of the majority shareholder's economic interest in the company. In addition, the new policy adds a baseline one-third independence threshold, which means that ISS will also generally recommend against the election or reelection of non-independent directors (excluding the CEO) at controlled companies if the level of independence is less than one-third. The one-third baseline independence threshold has been added out of the recognition that, due to the inherent governance risks of controlled companies, minority shareholders need a minimum level of protection on the board, in particular when the majority shareholder holds a commanding equity stake.

In markets where the local corporate governance code makes a specific recommendation on board independence at controlled companies, ISS will generally recommend in line with the local code. However, in any case, ISS will recommend against non-independent nominees (other than the CEO) if the level of independence on the board is below one-third.

This policy is only applicable in situations where a shareholder controls a majority of a company's equity capital. ISS will continue to apply the standard board independence policy to elections at companies that are controlled through other means (e.g. multiple share classes) if the controlling shareholder does not hold a majority of equity capital.

Board Independence (Greece)

Current Recommendation: ISS currently does not apply a policy on director independence for Greece.

Key Changes: Adopt a formal board independence policy for the Greek market.

New Recommendation: Vote against the election or reelection of any non-independent directors if the proposed board is not at least one-third independent (as defined by ISS' director classification guidelines). If elections are bundled and the proposed board is not at least one-third independent, vote against the entire slate. If a nominee cannot be categorized, ISS will assume that person is non-independent and include that nominee in the calculation. This policy will be applied to widely held* companies incorporated in Greece.

*ISS defines a "widely held" company using the following factors:

- Number of clients holding the security; and
- Membership in a major index.

Rationale for Update: Greece is the only core European market where ISS does not currently apply a board independence policy. Under the revised policy, the carve-out for Greece will be eliminated. Introducing a board independence policy for Greece is appropriate in light of the September 2010 implementation of the EU Shareholder Rights Directive and the introduction of a Greek Corporate Governance Code in March 2011. Nominee disclosure practices are steadily improving so shareholders are better able to assess the independence of the candidates. The new ISS policy is in line with the board independence recommendation contained in the Greek Corporate Governance Code.

Board Independence (Hungary)

Current Recommendation: ISS currently does not apply a policy on director independence for Hungary.

Key Changes: Include Hungary among the European markets where ISS will recommend against non-independent directors at widely held companies in cases where the board is not at least 50 percent independent. Also include Hungary among the European markets where ISS applies a carve-out for companies with employee representatives.

New Recommendation: For companies in Hungary, generally vote against the election or reelection of any non-independent directors (excluding the CEO) if the board is not at least 50 percent independent. If a nominee cannot be categorized, ISS will consider that person non-independent and include that nominee in the calculation for determining the board independence percentage. The policy will apply to widely held* companies.

*ISS defines a "widely held" company using the following factors:

- Number of clients holding the security; and
- Membership in a major index.

The above policy will apply to shareholder-elected board members. In addition, ISS will require that one-third of the total board (shareholder-elected members and labor representatives) be independent non-executive directors.

Rationale for Update: Starting in 2014, ISS will cover Eastern European EU Member States according to the ISS European Policy. This policy already applies independence requirements for board elections in most European markets, and the addition of Hungary to this list of markets is appropriate given Hungarian disclosure and practice.

Director Terms (Spain)

Current Recommendation: For the Spanish market, generally vote against the election of any director who will serve for a term exceeding four years (except the CEO).

However, ISS will evaluate a director election proposal when the proposed term exceeds four years (except for the CEO) taking into account the following factors:

- 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.

Key Changes: Remove the current policy carve-out for Spain and henceforth apply the continental European policy on director terms to companies incorporated in Spain.

New Recommendation: For the Spanish market, vote against the election or reelection of any director when his/her term is not disclosed or when it exceeds four years and adequate explanation for non-compliance has not been provided. This policy applies for bundled as well as unbundled items.

Rationale for Update: The new policy aims at aligning Spain with other continental European markets that have adopted four-year director terms. This follows the trend of Spanish companies, especially blue chip ones, decreasing their director terms for the past few years. This trend has been prompted by the Institute of Directors, an influential association representing directors of public companies in Spain. The Spanish government has also recently announced that it will propose a new law to reduce the maximum director term length to four years.

Compensation

Corporate Governance Issue: Executive Pay Levels (Europe)

Current Recommendation: Vote case-by-case on management proposals seeking ratification of a company's executive compensation-related items, and generally vote against a company's compensation-related proposal if such proposal fails to comply with one or a combination of several of the global principles and their corresponding rules:

3. Avoid arrangements that risk "pay for failure":

  3.1 Severance pay agreements must not be in excess of (i) 24 months' pay or of (ii) any more restrictive provision pursuant to local legal requirements and/or market best practices.

  3.2 Arrangements with a company executive regarding pensions and post-mandate exercise of equity-based awards must not result in an adverse impact on shareholders' interests or be misaligned with good market practices.

  3.3 The board shall demonstrate good stewardship of investor's interests regarding executive compensation practices.

    3.3.1 There shall be a clear link between the company's performance and variable awards.

    3.3.2 There shall not be significant discrepancies between the company's performance and real executive payouts.

Key Changes: Add two new subpoints to the European policy on compensation-related proposals in order to stipulate that the level of pay for the CEO and members of executive management should not be excessive, and that significant increases should be explained. As a result, the current sections 3.1 and 3.2 would become sections 3.2 and 3.3, while the former subpoint 3.3 would become 3.1.

New Recommendation: Vote case-by-case on management proposals seeking ratification of a company's executive compensation-related items, and generally vote against a company's compensation-related proposal if such proposal fails to comply with one or a combination of several of the global principles and their corresponding rules:

3. Avoid arrangements that risk "pay for failure":

  3.1 The board shall demonstrate good stewardship of investor's interests regarding executive compensation practices. For instance,

    3.1.1 There shall be a clear link between the company's performance and variable awards.

    3.1.2 There shall not be significant discrepancies between the company's performance and real executive payouts.

    3.1.3 The level of pay for the CEO and members of executive management should not be excessive relative to peers, company performance, and market practices.

    3.1.4 Significant pay increases shall be explained by a detailed and compelling disclosure.

  3.2 Severance pay agreements must not be in excess of (i) 24 months' pay or of (ii) any more restrictive provision pursuant to local legal requirements and/or market best practices.

  3.3 Arrangements with a company executive regarding pensions and post-mandate exercise of equity-based awards must not result in an adverse impact on shareholders' interests or be misaligned with good market practices.

Rationale for Update: The new policy amends the European compensation policy by introducing references to the level of executive pay in line with legislative changes in various European countries that will entitle shareholders to vote on the executive board's level of pay.

Capital Structure

Corporate Governance Issue:
Share Issuances without Preemptive Rights (France)

Current Recommendation: For companies in continental Europe, generally vote for general authorities to issue shares without preemptive rights, up to a maximum of 20 percent of share capital, as long as the share issuance authority's period is clearly disclosed (or implied by the application of a legal maximum duration) and in line with market-specific practices and/or recommended guidelines.

Key Changes: Reduce the acceptable threshold for general share issuances without preemptive rights from 20 percent of share capital to 10 percent for French companies. This change requires adding a policy carve-out for France.

New Recommendation: For French companies, generally vote for general authorities to issue shares without preemptive rights up to a maximum of 10 percent of share capital.

Rationale for Update: Since January 2013, the French Asset Management Association (AFG) has recommended that resolutions to increase share capital under exclusion of preemptive rights should be limited to 10 percent of share capital (compared to the previous recommendation of 15 percent). The updated policy would therefore bring the ISS guidelines into line with the AFG recommendation. It should be noted that the AFG recommendation on this issue has a significant impact in the French market, as there are no other legal requirements or best practice recommendations on the subject. In addition, many of ISS' European clients support having a lower maximum limit for general share issuances without preemptive rights.

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