



RiskMetrics Group

---

## ISS Governance Services

# US Corporate Governance Policy

2008 Updates

November 19, 2007

---

Copyright © 2007 by RiskMetrics Group.  
All rights reserved. No part of this publication may be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopy, recording, or any information storage and retrieval system, without permission in writing from the publisher. Requests for permission to make copies of any part of this work should be sent to: RiskMetrics Group Marketing Department, One Chase Manhattan Plaza, 44th Floor, New York, NY 10005. RiskMetrics Group is a trademark used herein under license.

# ISS Governance Services US Corporate Governance Policy 2008 Updates

Effective for Meetings on or after Feb 1, 2008  
Updated Nov 19, 2007

These policy updates present changes and clarifications to ISS Governance Services' ("ISS") US benchmark guidelines for 2008. 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.

AUDIT .....	3
Audit Fees for Initial Public Offerings, Bankruptcy Emergence and Spin-Offs.....	3
Poor Accounting Practices .....	3
BOARD .....	5
Voting on Director Nominees in Uncontested Elections.....	5
Withhold/Against Recommendations at Classified Boards .....	5
Adoption of Poison Pills without Shareholder Approval prior to Initial Public Offering .....	5
Performance Test for Directors .....	6
2008 Classification of Directors/Definition of Independence .....	7
Cumulative Voting.....	9
Shareholder Proposals Calling for Independent Chair .....	10
COMPENSATION .....	13
Advisory Votes on Executive Compensation (Say-on-Pay) Management Proposals.....	13
Binomial Model: Stock Option Overhang Cost .....	15
Burn Rate Multipliers .....	16
Burn Rate Table for 2008 .....	18
Poor Pay Practices .....	18
CORPORATE RESPONSIBILITY .....	22
Community Impact Assessments .....	22
Energy Efficiency .....	22
Facility Safety Policy .....	23
Internet Privacy and Censorship .....	24
Operations in High-Risk Markets .....	25
Product Safety .....	26

## AUDIT

### Corporate Governance Issue: Audit Fees for Initial Public Offerings, Bankruptcy Emergence and Spin-Offs

**Current Policy Position:** ISS Governance Services (“ISS”) recommends that shareholders withhold votes from, or vote against<sup>1</sup> Audit Committee members if non-audit fees (“other fees”) are excessive. ISS will recommend a vote against the ratification of auditors as well. The formula used to determine if the non-audit fees are excessive is as follows:

Non-audit (“other”) fees >(audit fees + audit-related fees + tax compliance/preparation fees)\*

\*Tax compliance and preparation include the preparation of original and amended tax returns, refund claims, and tax payment planning. All other services in the tax category, such as tax advice, planning, or consulting should be added to “Other” fees. If the breakout of tax fees cannot be determined, add all tax fees to “Other” fees.

#### New Policy Position:

In circumstances where “Other” fees include fees related to initial public offerings, bankruptcy emergence, and spin-offs, and the company makes public disclosure of the amount and nature of those fees which ISS determines to be an exception to the standard “non-audit fee” category, then such fees may be excluded from the non-audit fees considered in determining the ratio of non-audit to audit/audit-related fees/tax compliance and preparation for purposes of determining whether non-audit fees are excessive.

**Rationale for Update:** The updated policy aims to provide a more accurate assessment of non-audit fees for companies that undergo significant one-time capital structure events limited to IPOs, bankruptcy emergence and spin-offs. The updated policy will allow for consideration of an exception in these three cases, provided that shareholders have full disclosure regarding the nature of the expenses.

### Corporate Governance Issue: Poor Accounting Practices

**Current Policy Position:** ISS recommends withhold/against votes on members of the Audit Committee if a material weakness identified as per Section 404 of the Sarbanes-Oxley Act disclosures rises to a level of serious concern, there are chronic internal control issues, or there is an absence of established effective control mechanisms. ISS recommends a vote against management proposals to ratify auditors if there is reason to believe that the independent auditor has rendered an opinion which is neither accurate nor indicative of the company’s financial position.

**New Policy Position:** ISS will continue its focus on poor accounting practices including, in cases such as: fraud; misapplication of GAAP; and material weaknesses identified in Section 404 disclosures. In addition, for

---

<sup>1</sup> In general, companies with a plurality vote standard use “Withhold” as the valid contrary vote option in director elections; companies with a majority vote standard use “Against”. However, it will vary by company and the proxy must be checked to determine the valid contrary vote option for the particular company.

companies that have problematic practices, ISS will provide additional content and information in its analyses so that investors can make informed voting decisions. ISS may hold auditors and audit committee members accountable for poor accounting practices by recommending a withhold/against vote on audit committee members and against the ratification of the auditors.

**Rationale for Update:** The updated policy aims to broaden the focus on a range of accounting issues beyond poor internal control. ISS may utilize the forensic accounting research produced by RiskMetrics' Financial Research & Analysis staff and include their accounting insights in our proxy reports for key meetings.

## BOARD

### Corporate Governance Issue:

#### Voting on Director Nominees in Uncontested Elections

##### *Withhold/Against Recommendations at Classified Boards*

**Current Policy Position:** Our policy in voting for director nominees in uncontested elections does not specify recommendations in the case where a company has a classified board and a continuing director (not up for election) is responsible for a problematic governance issue at the board/committee level that would warrant a withhold/against vote recommendation.

**New Policy Position:** If the company has a classified board and a continuing director is responsible for a problematic governance issue at the board/committee level that would warrant a withhold/against vote recommendation, in addition to potential future withhold/against recommendations on that director, ISS may recommend a withhold/against vote from any or all of the nominees up for election, with the exception of new nominees.

**Rationale for Update:** The ability to elect directors is the single most important use of the shareholder franchise, and all directors should be accountable on an annual basis. Classified boards can reduce director accountability by shielding directors, at least for a certain period of time, from the consequences of their actions. Continuing directors who are responsible for a problematic governance issue at the board/committee level would avoid shareholders' reactions to their actions because they would not be up for election in that year. Ultimately, in these cases, the full board should be responsible for the actions of its directors.

##### *Adoption of Poison Pills without Shareholder Approval prior to Initial Public Offering*

**Current Policy Position:** ISS currently recommends to withhold from or vote against the entire board of directors, (except from new nominees, who should be considered on a CASE-BY-CASE basis) if:

The board adopts or renews a poison pill without shareholder approval since the beginning of 2005, does not commit to putting it to a shareholder vote within 12 months of adoption or reneges on a commitment to put the pill to a vote, and has not yet received a withhold recommendation for this issue.

**New Policy Position:** ISS will recommend to withhold from or vote against the entire board of directors, (except from new nominees, who should be considered on a CASE-BY-CASE basis) if:

The board adopts or renews a poison pill without shareholder approval, does not commit to putting it to shareholder vote within 12 months of adoption (or in the case of a newly public company, does not commit to put the pill to a shareholder vote within 12 months following the IPO), or reneges on a commitment to put the pill to a vote, and has not yet received a withhold recommendation for this issue.

**Rationale for Update:** Although the adoption of a poison pill at a privately-held company may technically have been approved by the private shareholders, the dramatic change in shareholder ownership associated with an IPO should necessitate the approval of the poison pill by the public shareholders. A poison pill adopted prior to

an IPO has little purpose at a private firm. Thus, the standard policy has been broadened to include IPO companies in addition to veteran public companies.

### *Performance Test for Directors*

**Current Policy Position:** In 2007, ISS' policy included a framework for analyzing corporate performance as it relates to potential withhold/against recommendations on director nominees at Russell 3000 companies.

The methodology evaluates companies using a combination of four performance measures. One measurement is a market-based performance metric and three measurements are tied to the company's operational performance. The market performance metric in the methodology is five-year Total Shareholder Return (TSR) on a relative basis within each four-digit GICS group. The three operational performance metrics are sales growth, EBITDA growth (or operating income growth for companies in the financial sector), and pre-tax operating Return on Invested Capital (ROIC) (or ROAA for companies in the financial sector) on a relative basis within each four-digit GICS group. All four metrics will be time-weighted as follows: 40 percent on the trailing 12 month period and 60 percent on the 48 month period prior to the trailing 12 months. This methodology emphasizes the company's historical performance over a five-year period yet also accounts for near-term changes in a company's performance.

The table below summarizes the framework:

Metrics	Basis of Evaluation	Weighting	2 <sup>nd</sup> Weighting
<i>Operational Performance</i>			50%
5-year Average pre-tax operating ROIC or ROAA*	Management efficiency in deploying assets	33.3%	
5-year Sales Growth	Top-Line	33.3%	
5-year EBITDA Growth or Operating Income Growth*	Core-earnings	33.3%	
Sub Total		100%	
<i>Stock Performance</i>			50%
5-year TSR	Market		
Total			100%

\*Metric applies to companies in the financial sector

In applying our policy, ISS adopted a two-phase approach. In 2007 (*Year 1*), the worst performers (bottom 5 percent) within each of the 24 GICS groups receive cautionary language in the ISS analysis, except for companies that have already received cautionary language or withhold recommendations in 2006. The latter were subject to potential withhold votes in 2007. For 2008 (*Year 2*), ISS may recommend WITHHOLD votes from

director nominees if a company continues to be in the bottom five percent within its GICS group for that respective year and/or shows no improvement in its most recent trailing 12 months operating and market performance relative to its peers in its GICS group. This policy would be applied on a rolling basis going forward.

**New Policy Position:** ISS will evaluate the company's overall performance relative to its peers on a case-by-case basis. The performance test policy will be incorporated into our overall evaluation of board performance.

**Rationale for Update:** More than ever, institutional investors want to use their voting rights in uncontested director elections to express their dissatisfaction to boards at under-performing companies. As a starting point, our two-phased approach adopted in 2007 identifies the worst performers within each of the GICS groups. However, corporate performance should be evaluated on a case-by-case basis taking into account the company's situational circumstances including, but not limited to, changes in the board or management and year-to-date total shareholder returns. Further, corporate performance should be considered in connection with the company's overall governance practices in determining vote recommendations for director nominees.

### Corporate Governance Issue:

#### 2008 Classification of Directors/Definition of Independence

**Current Policy Position:** A director who formerly served as CEO of a company is considered to be an affiliated outsider of such company.

**New Policy Position:** A director who formerly served as CEO of a company, including prior to the company's IPO, will be considered an affiliated outsider.

**Rationale for Update:** The current policy does not specifically address persons who served as CEO prior to a company's initial public offering (IPO), and the policy is being updated to clarify this point. Directors with ties to management other than their board seat may be perceived as less willing and able to effectively evaluate and scrutinize company strategy and performance. Such ties would include a former employment relationship with the company, particularly one in the highest executive capacity. Corporate governance best practices recognize that such relationships, and the potential that independence may be compromised, do not disappear simply because a company has made a transition from private to public status.

The following ISS Classification of Directors table has been updated to include the above policy change (footnote 3), and also to articulate the treatment of non-employee directors who serve as officers (footnote 2):

## ISS Classification of Directors - 2008

### Inside Director (I)

- Employee of the company or one of its affiliates<sup>1</sup>;
- Non-employee officer of the company if among the five most highly paid individuals (excluding interim CEO);
- Listed as a Section 16 officer<sup>2</sup>;
- Current interim CEO;
- Beneficial owner of more than 50 percent of the company's voting power (this may be aggregated if voting power is distributed among more than one member of a defined group).

### Affiliated Outside Director (AO)

- Board attestation that an outside director is not independent;
- Former CEO of the company<sup>3</sup>;
- Former CEO of an acquired company within the past five years;
- Former interim CEO if the service was longer than 18 months. If the service was between twelve and eighteen months an assessment of the interim CEO's employment agreement will be made;<sup>4</sup>
- Former executive<sup>2</sup> of the company, an affiliate or an acquired firm within the past five years;
- Executive<sup>2</sup> of a former parent or predecessor firm at the time the company was sold or split off from the parent/predecessor within the past five years;
- Executive<sup>2</sup>, former executive, general or limited partner of a joint venture or partnership with the company;
- Relative<sup>5</sup> of a current Section 16 officer of company or its affiliates;
- Relative<sup>5</sup> of a current employee of company or its affiliates where additional factors raise concern (which may include, but are not limited to, the following: a director related to numerous employees; the company or its affiliates employ relatives of numerous board members; or a non-Section 16 officer in a key strategic role);
- Relative<sup>5</sup> of former Section 16 officer, of company or its affiliate within the last five years;
- Currently provides (or a relative<sup>5</sup> provides) professional services<sup>6</sup> to the company, to an affiliate of the company or an individual officer of the company or one of its affiliates in excess of \$10,000 per year;
- Employed by (or a relative<sup>5</sup> is employed by) a significant customer or supplier<sup>7</sup>;
- Has (or a relative<sup>5</sup> has) any transactional relationship with the company or its affiliates excluding investments in the company through a private placement;<sup>7</sup>
- Any material financial tie or other related party transactional relationship to the company;
- Party to a voting agreement to vote in line with management on proposals being brought to shareholder vote;
- Has (or a relative<sup>5</sup> has) an interlocking relationship as defined by the SEC involving members of the board of directors or its Compensation and Stock Option Committee;<sup>8</sup>
- Founder<sup>9</sup> of the company but not currently an employee;
- Is (or a relative<sup>5</sup> is) a trustee, director or employee of a charitable or non-profit organization that receives grants or endowments<sup>7</sup> from the company or its affiliates<sup>1</sup>.

### Independent Outside Director (IO)

- No material<sup>10</sup> connection to the company other than a board seat.

### Footnotes:

<sup>1</sup> "Affiliate" includes a subsidiary, sibling company, or parent company. ISS uses 50 percent control ownership by the parent company as the standard for applying its affiliate designation.

<sup>2</sup> "Executives" (officers subject to Section 16 of the Securities and Exchange Act of 1934) include the chief executive, operating, financial, legal, technology, and accounting officers of a company (including the president, treasurer, secretary, controller, or any vice president in charge of a principal business unit, division or policy

function). A non-employee director serving as an officer due to statutory requirements (e.g. corporate secretary) will be classified as an Affiliated Outsider. If the company provides additional disclosure that the director is not receiving additional compensation for serving in that capacity, then the director will be classified as an Independent Outsider.

<sup>3</sup> Includes any former CEO of the company prior to the company's initial public offering (IPO).

<sup>4</sup> ISS will look at the terms of the interim CEO's employment contract to determine if it contains severance pay, long-term health and pension benefits or other such standard provisions typically contained in contracts of permanent, non-temporary CEOs. ISS will also consider if a formal search process was underway for a full-time CEO at the time.

<sup>5</sup> "Relative" follows the SEC's new definition of "immediate family members" which covers spouses, parents, children, step-parents, step-children, siblings, in-laws, and any person (other than a tenant or employee) sharing the household of any director, nominee for director, executive officer, or significant shareholder of the company.

<sup>6</sup> Professional services can be characterized as advisory in nature and generally include the following: investment banking / financial advisory services; commercial banking (beyond deposit services); investment services; insurance services; accounting/audit services; consulting services; marketing services; and legal services. The case of participation in a banking syndicate by a non-lead bank should be considered a transaction (and hence subject to the associated materiality test) rather than a professional relationship.

<sup>7</sup> If the company makes or receives annual payments exceeding the greater of \$200,000 or 5 percent of the recipient's gross revenues. (The recipient is the party receiving the financial proceeds from the transaction).

<sup>8</sup> Interlocks include: (a) executive officers serving as directors on each other's compensation or similar committees (or, in the absence of such a committee, on the board); or (b) executive officers sitting on each other's boards and at least one serves on the other's compensation or similar committees (or, in the absence of such a committee, on the board).

<sup>9</sup> The operating involvement of the Founder with the company will be considered. Little to no operating involvement may cause ISS to deem the Founder as an independent outsider.

<sup>10</sup> For purposes of ISS' director independence classification, "material" will be defined as a standard of relationship (financial, personal or otherwise) that a reasonable person might conclude could potentially influence one's objectivity in the boardroom in a manner that would have a meaningful impact on an individual's ability to satisfy requisite fiduciary standards on behalf of shareholders.

## Corporate Governance Issue: Cumulative Voting

**Current Policy Position:** ISS currently generally recommends voting FOR proposals to restore or provide for cumulative voting unless the company meets *all* of the following criteria:

- Majority vote standard in director elections, including a carve-out for plurality voting in contested situations;
- Annually elected board;
- Two-thirds of the board composed of independent directors;
- Nominating committee composed solely of independent directors;
- Confidential voting; however, there may be a provision for suspending confidential voting during proxy contests;
- Ability of shareholders to call special meetings or act by written consent with 90 days' notice;

- Absence of superior voting rights for one or more classes of stock;
- Board does not have the right to change the size of the board beyond a stated range that has been approved by shareholders;
- The company has not under performed its peers and index on a one-year and three-year basis, unless there has been a change in the CEO position within the last three years; and
- No director received a WITHHOLD vote level of 35% or more of the votes cast in the previous election.

ISS will generally recommend AGAINST proposals to eliminate cumulative voting.

#### **New Policy Position:**

ISS will generally recommend AGAINST proposals to eliminate cumulative voting, and FOR proposals to restore or provide for cumulative voting unless:

- the company has proxy access or a similar structure<sup>2</sup> to allow shareholders to nominate directors to the company's ballot, and
- The company has adopted a majority vote standard, with a carve-out for plurality in situations where there are more nominees than seats, and a director resignation policy to address failed elections.

ISS will recommend a vote FOR proposals for cumulative voting at controlled companies (insider voting power > 50%).

**Rationale for Update:** Under the current policy, ISS would examine specific governance factors as an acceptable alternative to cumulative voting. Even though these factors did not directly address vote standards, the rationale was that if the company showed evidence of board independence, impartiality in the nominating process, and accountability to shareholders, this was sufficient to offset the need for cumulative voting. We have re-examined our policy in light of the introduction of proxy access and majority voting that directly address the voting process. A majority vote standard ensures board accountability in uncontested elections. In contested elections, similar to cumulative voting, proxy access allows shareholder access to the ballot without a veto from the nominating committee, but unlike cumulative voting, it also requires majority support to elect such directors.

At controlled companies, where majority insider control would preclude minority shareholders from having any representation on the board, cumulative voting would allow such representation and shareholder proposals for cumulative voting would be supported.

#### **Corporate Governance Issue: Shareholder Proposals Calling for Independent Chair**

**Current Policy Position:** ISS generally recommends FOR shareholder proposals requiring the position of chairman be filled by an independent director, unless there are compelling reasons to recommend against the proposal, such as a counterbalancing governance structure. This should include all of the following:

---

<sup>2</sup> Similar structure" would be a structure that allows shareholders to nominate candidates who the company will include on the management ballot IN ADDITION TO management's nominees, and their bios are included in management's proxy.

- Designated lead director, elected by and from the independent board members with clearly delineated duties. (The role may alternatively reside with a presiding director, vice chairman or rotating lead director). At a minimum these duties should include:
  - presides at all meetings of the board at which the chairman is not present, including executive sessions of the independent directors;
  - serves as liaison between the chairman and the independent directors;
  - approves information sent to the board;
  - approves meeting agendas for the board;
  - approves meeting schedules to assure that there is sufficient time for discussion of all agenda items;
  - has the authority to call meetings of the independent directors;
  - if requested by major shareholders, ensures that he is available for consultation and direct communication
- Two-thirds independent board;
- All independent key committees;
- Established governance guidelines;
- The company should not have underperformed both its peers and index on the basis of both one-year and three-year total shareholder returns, unless there has been a change in the Chairman/CEO position within that time; and
- The company does not have any problematic governance issues.

**New Policy Position:** ISS has added two additional considerations in its evaluation of shareholder proposals calling for an independent chair: disclosure of a comparison of the duties of the lead director and the Chairman; and the disclosure of a rationale for choosing the combined CEO/Chair structure as opposed to appointing an independent Chair. Under the new policy ISS will generally recommend FOR shareholder proposals requiring that the chairman's position be filled by an independent director, unless there are compelling reasons to recommend against the proposal, such as a counterbalancing governance structure. ISS will look for all the following:

- Designated lead director, elected by and from the independent board members with clearly delineated and comprehensive duties. (The role may alternatively reside with a presiding director, vice chairman, or rotating lead director; however the director must serve a minimum of one year in order to qualify as a lead director.) The duties should include, but are not limited to, the following:
  - presides at all meetings of the board at which the chairman is not present, including executive sessions of the independent directors;
  - serves as liaison between the chairman and the independent directors;
  - approves information sent to the board;
  - approves meeting agendas for the board;
  - approves meeting schedules to assure that there is sufficient time for discussion of all agenda items;

- has the authority to call meetings of the independent directors;
- if requested by major shareholders, ensures that he is available for consultation and direct communication;
- *The company publicly discloses a comparison of the duties of its independent lead director and its chairman\**;
- *The company publicly discloses a sufficient explanation of why it chooses not to give the position of chairman to the independent lead director, and instead to combine the chairman and CEO positions\**;
- Two-thirds independent board;
- All independent key committees;
- Established governance guidelines;
- The company should not have underperformed both its peers and index on the basis of both one-year and three-year total shareholder returns, unless there has been a change in the Chairman/CEO position within that time; and
- The company does not have any problematic governance issues.

\* *New considerations.*

ISS may recommend a vote FOR the proposal if the company does not provide disclosure with respect to any or all of the bullet points above. If disclosure is provided, ISS will evaluate on a CASE-BY-CASE basis.

**Rationale for Update:** For several years there has been an ongoing debate over the merits of a separate and independent board chair versus a combined or non-independent chairman/CEO structure. While the latter has been a prevalent practice among US companies for many years, some investors argue that the combined role limits accountability and is indicative of poor governance structure.

Given the growing importance of the functions of an independent lead director versus the best governance practice of appointing an independent chair, the new policy adds two additional factors for consideration: (1) a comparison between the duties of its independent lead director and non-independent chairman; and (2) a sufficient explanation for not appointing an independent chair and instead maintaining both a non-independent chair and an independent lead director. The purpose of the updated policy is to gain more insight from companies on the duties of the lead director, a rationale for maintaining a combined chair/CEO structure, and any associated benefits to shareholders of not appointing an independent chair.

## COMPENSATION

### Corporate Governance Issue: Advisory Votes on Executive Compensation (Say-on-Pay) Management Proposals

**Current Policy Position:** Evaluations are made on a case-by-case basis in each market where these proposals routinely appear on proxy ballots (including the U.K., Australia, the Netherlands, Sweden, Norway, and some companies in Denmark). Evaluations take into account specific proposal wording and local market regulations and best practice codes, as well as prevailing practices. Key factors influencing these evaluations generally fall into the following categories:

1. Pay in relation to performance, usually based on the design of programs and actual grants (e.g., the use of rigorous performance hurdles);
2. Equity-based awards, which should not exceed levels recommended under local best practice codes;
3. "Pay for failure" arrangements, such as long-term contracts that could lead to multiple-year severance packages;
4. The quality of pay disclosures (e.g., specifying incentive goals that generated past-year rewards and/or forward-looking targets); and
5. In some markets, aspects of non-executive directors' pay (e.g., codes in several markets discourage stock-based grants to non-executive directors), designed to ensure that pay does not compromise outside directors' independence.

**New Policy Position:** Assessment of pay programs will be guided by the new global principles and the U.S. guidelines presented below, and will be assessed on a case-by-case basis. ISS may recommend against these resolutions in cases where boards have failed to demonstrate good stewardship of investors' interests regarding executive compensation practices.

1. The following five global principles underlie market-specific policies in all markets:

- Maintain appropriate pay-for-performance alignment with emphasis on long-term shareholder value: This principle encompasses overall executive pay practices, which must be designed to attract, retain, and appropriately motivate the key employees who drive shareholder value creation over the long term. It will take into consideration, among other factors: the linkage between pay and performance; the mix between fixed and variable pay; performance goals; and equity-based plan costs;
- Avoid arrangements that risk "pay for failure": This principle addresses the use and appropriateness of long or indefinite contracts, excessive severance packages, and guaranteed compensation;

- Maintain an independent and effective compensation committee: This principle promotes oversight of executive pay programs by directors with appropriate skills, knowledge, experience, and a sound process for compensation decision-making (e.g., including access to independent expertise and advice when needed);
- Provide shareholders with clear, comprehensive compensation disclosures: This principle underscores the importance of informative and timely disclosures that enable shareholders to evaluate executive pay practices fully and fairly;
- Avoid inappropriate pay to non-executive directors: This principle recognizes the interests of shareholders in ensuring that compensation to outside directors does not compromise their independence and ability to make appropriate judgments in overseeing managers' pay and performance. At the market level, it may incorporate a variety of generally accepted best practices.

2. Implementation of guidelines for U.S. market say-on-pay proposals: ISS will evaluate management proposals seeking ratification of a U.S. company's compensation program on a case-by-case basis. The following factors are among those that may be considered in these evaluations, in the context of each company's specific circumstances and the board's disclosed rationale for its practices:

Relative Considerations:

- Assessment of performance metrics relative to business strategy, as discussed and explained in the CD&A;
- Evaluation of peer groups used to set target pay or award opportunities;
- Alignment of company performance and executive pay trends over time (e.g., performance down: pay down);
- Assessment of disparity between total pay of the CEO and other Named Executive Officers (NEOs).

Design Considerations:

- Balance of fixed versus performance-driven pay;
- Assessment of excessive practices with respect to perks, severance packages, supplemental executive pension plans, and burn rates.

*Communication Considerations:*

- Evaluation of information and board rationale provided in CD&A about how compensation is determined (e.g., why certain elements and pay targets are used, and specific incentive plan goals, especially retrospective goals);
- Assessment of board's responsiveness to investor input and engagement on compensation issues (e.g., in responding to majority supported shareholder proposals on executive pay topics).

**Rationale for Update:** Shareholder votes on pay programs are designed to ensure transparency and accountability in executive compensation, and encourage pay practices (and constructive dialogue) that elicit investor support for them - i.e., the practices promoted by the proposed global principles. Currently, remuneration approval resolutions (some binding) appear on annual ballots in the U.K., Australia, the Netherlands, Sweden, Norway, and at some companies in Denmark. The list of countries will be expanding: Spain's say-on-pay provision takes effect in 2008; and France just recently adopted a binding vote requirement that will come into effect in 2009 and permit shareholder ratification of severance arrangements for the Chair and CEO of its listed companies. In the U.S., the first management proposal for a shareholder vote on pay programs is expected to appear on ballot in 2008, with additional companies implementing in 2009. Shareholder proposals calling for U.S. companies to seek advisory votes on pay have received strong support, pointing towards the probability of more companies adopting the practice.

Market distinctions preclude development of a single global policy for say-on-pay votes; however, the global principles provide a universal framework for development of policies across all markets with respect to evaluating executive and director pay. The criteria for U.S. say-on-pay vote evaluations fall within the scope of the proposed global principles and emphasize investors' demand for executive compensation programs that have a strong link to performance and minimize non-performance or potential "pay for failure" components.

### Corporate Governance Issue: Binomial Model: Stock Option Overhang Cost

**Current Policy Position:** ISS evaluates equity-based compensation plans using a cost-based analysis. The cost of an equity plan is expressed in terms of shareholder value transfer (SVT), which is measured using a binomial option pricing model that assesses the amount of shareholders' equity flowing out of the company to participants as options are exercised and/or restrictions on awards lapse. When analyzing the cost of a new plan or an amendment to add additional shares to an existing plan, ISS estimates the total cost of a company's equity compensation program, including: (1) new shares reserved, (2) shares available under all existing equity compensation plans, and (3) shares subject to outstanding awards or overhang. The total cost or SVT of all plans is then compared to a company-specific cap that is both industry and performance-based.

**New Policy Position:** Companies with sustained positive stock performance and high overhang cost attributable to in-the-money options outstanding in excess of six years may receive a carve-out of these options from the overhang as long as the dilution attributable to the new share request is reasonable and the company exhibits sound compensation practices. ISS will consider, on a case-by-case basis, a carve-out of a portion of cost attributable to overhang, considering the following criteria:

- **Performance:** Companies with sustained positive stock performance will merit greater scrutiny. Five-year total shareholder return (TSR), year-over-year performance, and peer performance could play a significant role in this determination.
- **Overhang Disclosure:** ISS will assess whether optionees have held in-the-money options for a prolonged period (thus reflecting their confidence in the prospects of the company). Note that this assessment would require additional disclosure regarding a company's overhang. Specifically, the following disclosure would be required:

- The number of in-the-money options outstanding in excess of six or more years with a corresponding weighted average exercise price and weighted average contractual remaining term;
- The number of all options outstanding less than six years and underwater options outstanding in excess of six years with a corresponding weighted average exercise price and weighted average contractual remaining term;
- The general vesting provisions of option grants; and
- The distribution of outstanding option grants with respect to the named executive officers;
- **Dilution:** ISS will calculate the expected duration of the new share request in addition to all shares currently available for grant under the equity compensation program, based on the company's three-year average burn rate (or a burn-rate commitment that the company makes for future years). The expected duration will be calculated by multiplying the company's unadjusted (options and full-value awards accounted on a one-for-one basis) three-year average burn rate by the most recent fiscal year's weighted average shares outstanding (as used in the company's calculation of basic EPS) and divide the sum of the new share request and all available shares under the company's equity compensation program by the product. For example, an expected duration in excess of five years could be considered problematic; and
- **Compensation Practices:** An evaluation of overall practices could include: (1) stock option repricing provisions, (2) high concentration ratios (of grants to top executives), or (3) additional practices outlined in the ISS current poor pay practices policy.

**Rationale for Update:** Companies with sustained positive stock performance may exhibit high SVT costs attributable to overhang if optionees hold their options for prolonged periods. Such a combination likely reflects employees' confidence in their company's future prospects. However, ISS may recommend a vote against a new share request due to excessive cost that is driven primarily by overhang. Although positive stock performance will typically result in a higher allowable cap for a company (and an increase in market capitalization), the high cost of overhang may still represent a significant component of SVT. In addition, although most full-value awards (such as time-based restricted shares) fully vest after no more than three or five years, most stock options are granted with 10-year terms, and thus may impact overhang for a longer period than full-value awards if not exercised within five years after they are granted. The six-year threshold was determined based on general option vesting and exercise trends. Options are generally granted with vesting periods of less than five years and are typically exercised within six years of the date of grant. The proposed case-by-case approach would be invoked in situations in which a company keeps its employees and the employees hold the options for prolonged periods of sustained positive stock performance. Such cases may represent successful retention of employees, who have a positive outlook on the future performance of the company.

## Corporate Governance Issue: Burn Rate Multipliers

**Current Policy Position:** ISS' current policy is to generally recommend AGAINST equity-based compensation plans if the company's average three-year burn rate (total of grants made divided by total outstanding

common) exceeds one standard deviation higher than the industry mean (based on GICS category), and is greater than 2 percent. Under the current policy, each year's burn rate is calculated as follows:

Burn rate = (# of options granted + # of full value shares awarded \* Multiplier) / fiscal-year-end Total Common Shares Outstanding

For companies that grant both full value awards and stock options to their employees, ISS applies a multiplier on full value awards for the past three fiscal years. The guideline for applying the multiplier is as follows:

Characteristics	Annual Stock Price Volatility	Multiplier
High annual volatility	53% and higher	1 full-value award will count as 1.5 option shares
Moderate annual volatility	25% - 52%	1 full-value award will count as 2.0 option shares
Low annual volatility	Less than 25%	1 full-value award will count as 4.0 option shares

**New Policy Position:** The following modifications are made to the current policy:

- The weighted average common shares outstanding rather than the fiscal year end figure will be used as the denominator.
- The number of brackets used to determine the multiplier for full-value shares is expanded from three to six, as follows:

Annual Stock Price Volatility	Multiplier
54.6% and higher	1 full-value award will count as 1.5 option shares
36.1% or higher and less than 54.6%	1 full-value award will count as 2.0 option shares
24.9% or higher and less than 36.1%	1 full-value award will count as 2.5 option shares
16.5% or higher and less than 24.9%	1 full-value award will count as 3.0 option shares
7.9% or higher and less than 16.5%	1 full-value award will count as 3.5 option shares
Less than 7.9%	1 full-value award will count as 4.0 option shares

**Rationale for Update:** The modifications are intended to add more precision to the current policy. First, using the weighted average common shares outstanding rather than the fiscal year-end figure will better account for the impact on a company that has significantly changed its outstanding shares during the year, either through stock buybacks or stock issuances. Second, the expanded list of multipliers will provide a more gradual distribution for full-value shares on a converted basis based on each company's actual volatility.

## Burn Rate Table for 2008

Russell 3000					Non-Russell 3000		
GICS	Description	Mean	Standard Deviation	Mean+STDEV	Mean	Standard Deviation	Mean+STDEV
1010	Energy	1.71%	1.39%	3.09%	2.12%	2.31%	4.43%
1510	Materials	1.16%	0.77%	1.93%	2.23%	2.26%	4.49%
2010	Capital Goods	1.51%	1.04%	2.55%	2.36%	2.03%	4.39%
2020	Commercial Services & Supplies	2.35%	1.70%	4.05%	2.20%	2.03%	4.23%
2030	Transportation	1.59%	1.22%	2.80%	2.02%	2.08%	4.10%
2510	Automobiles & Components	1.89%	1.10%	2.99%	1.73%	2.05%	3.78%
2520	Consumer Durables & Apparel	2.02%	1.31%	3.33%	2.10%	1.94%	4.04%
2530	Hotels Restaurants & Leisure	2.15%	1.18%	3.33%	2.32%	1.93%	4.25%
2540	Media	1.92%	1.35%	3.27%	3.33%	2.60%	5.93%
2550	Retailing	1.86%	1.04%	2.90%	3.15%	2.65%	5.80%
3010, 3020, 3030	Food & Staples Retailing	1.69%	1.23%	2.92%	1.82%	2.03%	3.85%
3510	Health Care Equipment & Services	2.90%	1.67%	4.57%	3.75%	2.65%	6.40%
3520	Pharmaceuticals & Biotechnology	3.30%	1.66%	4.96%	4.92%	3.77%	8.69%
4010	Banks	1.27%	0.88%	2.15%	1.07%	1.12%	2.19%
4020	Diversified Financials	2.45%	2.07%	4.52%	4.41%	5.31%	9.71%
4030	Insurance	1.21%	0.93%	2.14%	2.07%	2.28%	4.35%
4040	Real Estate	1.04%	0.81%	1.85%	0.80%	1.21%	2.02%
4510	Software & Services	3.81%	2.30%	6.11%	5.46%	3.81%	9.27%
4520	Technology Hardware & Equipment	3.07%	1.74%	4.80%	3.43%	2.40%	5.83%
4530	Semiconductors & Semiconductor Equipment	3.78%	1.81%	5.59%	4.51%	2.30%	6.81%
5010	Telecommunication Services	1.57%	1.23%	2.80%	2.69%	2.41%	5.10%
5510	Utilities	0.72%	0.50%	1.22%	0.59%	0.66%	1.25%

### Corporate Governance Issue: Poor Pay Practices

**Current Policy Position:** In general, ISS may recommend a withhold/against vote on compensation committee members, CEO, and potentially the entire board, if the company has poor compensation practices. In addition, ISS also recommends against equity plans if the plan is a vehicle for poor compensation practices. The following practices, while not exhaustive, are examples of poor compensation practices that may warrant withholding votes:

- Egregious employment contracts (e.g., those containing multi-year guarantees for bonuses and grants);
- Excessive perks that dominate compensation (e.g., tax gross-ups for personal use of corporate aircraft);
- Huge bonus payouts without justifiable performance linkage or proper disclosure;
- Performance metrics that are changed (e.g., canceled or replaced during the performance period without adequate explanation of the action and the link to performance);

- Egregious pension/SERP (supplemental executive retirement plan) payouts (e.g., the inclusion of additional years of service not worked or inclusion of performance-based equity awards in the pension calculation);
- New CEO awarded an overly generous new hire package (e.g., including excessive “make whole” provisions or any of the poor pay practices listed in this policy);
- Excessive severance provisions (e.g., including excessive change-in-control payments);
- Change-in-control payouts without loss of job or substantial diminution of job duties;
- Internal pay disparity;
- Options backdating (covered in a separate policy); and
- Other excessive compensation payouts or poor pay practices at the company.

**New Policy Position:** The current policy continues to apply with the following additions or clarifications:

- ISS may recommend withhold/against votes in cases where cautionary language has previously been applied but the poor practices (unless contractually bound) have not been remedied;
- Examples of poor pay practices are expanded to include multi-year base salary increases that are guaranteed as part of an employment contract, and perquisites for former executives such as car allowances, personal use of corporate aircraft, or other inappropriate arrangements;
- The category of “poor disclosure” has been added; and
- Base salary will be used as a relative measure to determine if certain perks are deemed excessive.

The following practices, while not exhaustive, are examples of poor compensation practices that may warrant withholding votes:

- Egregious employment contracts:
  - Contracts containing multi-year guarantees for salary increases, bonuses, and equity compensation;
- Excessive perks:
  - Overly generous cost and/or reimbursement of taxes for personal use of corporate aircraft, personal security systems maintenance and/or installation, car allowances, and/or other excessive arrangements relative to base salary;
- Abnormally large bonus payouts without justifiable performance linkage or proper disclosure:
  - Performance metrics that are changed, canceled, or replaced during the performance period without adequate explanation of the action and the link to performance;
- Egregious pension/SERP (supplemental executive retirement plan) payouts:
  - Inclusion of additional years of service not worked that result in significant payouts
  - Inclusion of performance-based equity awards in the pension calculation;
- New CEO with overly generous new hire package:
  - Excessive “make whole” provisions;
  - Any of the poor pay practices listed in this policy;
- Excessive severance and/or change-in-control provisions:

- Inclusion of excessive change-in-control or severance payments, especially those with a multiple in excess of 3X cash pay;
  - Severance paid for a “performance termination,” (i.e., due to the executive’s failure to perform job functions at the appropriate level);
  - Change-in-control payouts without loss of job or substantial diminution of job duties (single-triggered);
  - Perquisites for former executives such as car allowances, personal use of corporate aircraft or other inappropriate arrangements;
- Poor disclosure practices:
    - Unclear explanation of how the CEO is involved in the pay setting process;
    - Retrospective performance targets and methodology not discussed;
    - Methodology for benchmarking practices and/or peer group not disclosed and explained;
  - Internal Pay Disparity:
    - Excessive differential between CEO total pay and that of next highest paid named executive officer (NEO);
  - Options backdating (covered in a separate policy);
  - Other excessive compensation payouts or poor pay practices at the company.

ISS believes that executive pay programs should be fair, competitive, reasonable, and appropriate, and that pay for performance should be a central tenet in executive compensation philosophy. To that end, ISS is providing updated examples of best pay practices:

- ***Employment contracts:*** Companies should enter into employment contracts under limited circumstances for a short time period (e.g., new executive hires for a three-year contract) for limited executives. The contracts should not have an automatic renewal feature and should have a specified termination date.
- ***Severance agreements:*** Severance provisions should not be so appealing that it becomes an incentive for the executive to be terminated. Severance provisions should exclude excise tax gross-ups. The severance formula should be reasonable and not overly generous to the executive (e.g., severance multiples - 1X, 2X or 3X, use pro-rated target/average historical bonus and not maximum bonus). Failure to renew employment contract, termination under questionable events, or termination for poor performance should not constitute good reasons for severance payments.
- ***Change-in-control payments:*** Change-in-control payments should only be made when there is a significant change in company ownership structure, **and** when there is a loss of employment or substantial change in job duties associated with the change in company ownership structure (“double-triggered”). Change-in-control provisions should exclude excise tax gross-up and eliminate the acceleration of vesting of equity awards upon a change in control unless provided under a double-trigger scenario.

- **Supplemental executive retirement plans (SERPs):** Sweeteners that can increase the SERP value significantly or even exponentially, such as additional years of service credited for pension calculation, or inclusion of variable pay (e.g. bonuses and equity awards), should not enter into the SERP formula. Pension formulas should not reference extraordinary annual bonuses paid close to retirement years or maximum level of compensation earned.
- **Deferred compensation:** Above-market returns or guaranteed minimum returns should not be applied on deferred compensation.
- **Disclosure practices:** The Compensation Discussion and Analysis (CD&A) should be written in plain English, with as little “legalese” as possible and formatted using section headers, bulleted lists, tables, and charts where possible to ease reader comprehension. Ultimately, the document should provide detail and rationale regarding compensation, strategy, pay mix, goals/metrics, challenges, competition and pay-for-performance linkage, etc. in a narrative fashion.

**Rationale for Update:** In updating this policy, ISS will consider the cases of companies that received cautionary language but the poor pay practices (unless contractually bound) have not been remedied. In these instances, the company has had ample opportunity to review pay practices among its stated competition and/or general market and make appropriate adjustments.

In the examples of compensation practices, examples of poor pay practices that have been added include: base salary increases that are guaranteed as part of an employment contract (given the absence of a pay-for-performance tie); and perquisites for former executives such as car allowances, personal use of corporate aircraft, or other inappropriate arrangements. While former executives may have ongoing consulting arrangements, they should not receive perquisites at shareholder expense that are not integral to performing any ongoing role. Also, the category of “poor disclosure” has been added as a result of general ISS client feedback; this topic received considerable attention in the recently released SEC Comment Letters focusing on executive compensation disclosure. Many companies failed to provide clear explanation of the CEO’s involvement in the pay setting process and the methodology for benchmarking practices and pay strategy. Additionally, retrospective performance targets and methodology for annual incentive plans should be disclosed and should not pose competitive harm. Disclosure of retrospective performance targets will allow shareholders to better assess bonus plan results and not just rely on vague references to performance outcomes.

Best pay practices have been updated to include clear disclosure: focusing on making the Compensation Discussion and Analysis more readable to the average investor.

## CORPORATE RESPONSIBILITY

### Corporate Governance Issue: Community Impact Assessments

**Current Policy Position:** Currently, resolutions regarding business risk and environmental risks to a specified region are evaluated under the general environmental policy.

**New Policy Position:** ISS will recommend CASE-BY-CASE on requests for reports outlining the potential community impact of company operations in specific regions considering:

- Current disclosure of applicable risk assessment report(s) and risk management procedures;
- The impact of regulatory non-compliance, litigation, remediation, or reputational loss that may be associated with failure to manage the company's operations in question, including the management of relevant community and stakeholder relations;
- The nature, purpose, and scope of the company's operations in the specific region(s); and
- The degree to which company policies and procedures are consistent with industry norms.

**Rationale for Update:** This policy focuses on proposals requesting companies to evaluate and report on their policies and practices within the often unique and distinct regional concerns cited by the proponents. Examples of recent shareholder proposals include requests for companies to review potential environmental and public health damage resulting from certain regional operations, or requests for companies to study and develop a report on the potential environmental and public health damage of its operations.

As the global economy and need for resources continues to expand, companies increasingly find themselves operating in markets where stakeholders have competing interests. Stakeholders are often concerned over the possible social, cultural, and environmental impacts resulting from a company's operations. This is particularly evident in the mining, manufacturing, oil and gas, and extractive industries. Operating in such markets benefits the companies as well as the local communities, developing economies, and other stakeholders. Some developing countries can be plagued by poor infrastructure, social and political unrest, and corruption, substandard regulatory and legal systems, and a variety of other health and safety concerns. While the regulatory oversight of these issues may fall under the purview of host country governments, a significant level of responsibility rests with the companies that may operate or develop assets in these markets.

Social and environmental controversy, fines, and litigation can have a significant negative impact on a company's financial performance, public reputation, and license to operate in developing markets. Because of this responsibility, many companies that operate in such markets develop internal controls that seek to mitigate their exposure to these risks by enforcing, supplementing, and in many cases, exceeding local regulations and laws. In addition to internal policies, it is common for companies operating in developing markets to maintain outreach programs to the community, stakeholders and government to foster a collaborative approach to public health and sustainable development. We contend that companies with high impact and/or international operations should take appropriate steps to ensure that its operations are conducted in a manner that protects human rights, public health, and the environment.

### Corporate Governance Issue: Energy Efficiency

**Current Policy Position:** None

**New Policy Position:** ISS will recommend CASE-BY-CASE on proposals requesting a company report on its energy efficiency policies, considering:

- The current level of disclosure related to energy efficiency policies, initiatives, and performance measures;
- The company's level of participation in voluntary energy efficiency programs and initiatives;
- The company's compliance with applicable legislation and/or regulations regarding energy efficiency; and
- The company's energy efficiency policies and initiatives relative to industry peers.

**Rationale for Update:**

In response to mounting concerns over climate change and energy security, shareholder proponents have asked companies to report on their energy efficiency initiatives. While the issues of climate change and energy security have traditionally been viewed as presenting greater risks and opportunities to companies operating in the auto, energy, and extractive industries, it is increasingly evident that the business implications of these issues transcend a broader universe of industries. Companies can offset the risks and generate substantial opportunities by actively managing and disclosing their initiatives relating to energy efficiency.

Over the past several years some retailers have, in varying degrees, begun to disclose their energy efficiency and climate change-related policies by publicly committing to setting goals for energy use, reducing GHG emissions from operations, setting targets for renewable energy and formalizing energy efficiency policies. In recent years, shareholders have targeted certain retailers and residential builders and commercial real estate companies with energy efficiency-related shareholder proposals. Recently, the proposals have asked companies to report on their assessment and response to rising regulatory, competitive, and public pressure to increase energy efficiency.

While ISS will typically support calls to disclose energy efficiency initiatives and practices, we must also balance the cost implication of certain requests for improving energy efficiency. We encourage disclosure and implementation of energy efficiency policies and practices to mitigate energy risks and enhance opportunities to conserve energy. However, we are cognizant that retrofitting systems/fleets to increase efficiency is a costly proposition, as is implementing new technology to make buildings and operations more efficient. As such, the savings of certain energy efficiency initiatives may not always outweigh the costs of implementing these initiatives. Therefore, we will be more supportive of disclosure-based requests, while recommending against prescriptive requests for companies to achieve energy efficiency goals within prescribed timelines.

**Corporate Governance Issue:**  
**Facility Safety Policy**

**Current Policy Position:** As it relates to nuclear safety shareholder proposals, ISS has generally recommended AGAINST resolutions requesting that companies report on risks associated with their nuclear reactor designs and/or the production and interim storage of irradiated fuel rods, unless: the company does not have publicly disclosed guidelines describing its policies and procedures for addressing risks associated with its operations; the company is non-compliant with Nuclear Regulatory Commission (NRC) requirements; or the company stands out amongst its peers or competitors as having significant problems with safety or environmental performance related to its nuclear operations.

**New Policy Position:** ISS will recommend CASE-BY-CASE on resolutions requesting that companies report on risks associated with their operations and/or facilities, considering:

- The company's compliance with applicable regulations and guidelines;
- The level of existing disclosure related to security and safety policies, procedures, and compliance monitoring; and
- The existence of recent, significant violations, fines, or controversy related to the safety and security of the company's operations and/or facilities.

**Rationale for Update:** ISS is amending its existing Nuclear Safety Policy to expand the scope of the policy to address shareholder requests for companies to adopt policies to reduce the danger of potential catastrophic chemical releases at chemical and/or manufacturing plants. With the heightened concerns relating to terrorist activity and national security, shareholder proponents have introduced a new proposal relating to large manufacturing facilities which could have potentially catastrophic chemical release. Proponents concerned with nuclear safety have in the past requested that companies take initiatives to reduce the release of radioactive substances and improve monitoring these releases from its routine operations.

This policy approach to facility safety provides a broad approach to evaluating these proposals without limiting our ability to evaluate the safety risks of operating nuclear, chemical, manufacturing plants, or otherwise. We believe that there is significant overlap in how companies should be managing their facility safety/security and reporting this information to shareholders. Generally, ISS will expect companies to comply with existing regulations and guidelines while disclosing, within legal and regulatory limits, its security and safety policies, procedures and compliance monitoring mechanisms. The purpose of this disclosure is to demonstrate the company's commitment to managing its operational safety risks while simultaneously preserving and protecting shareholder value.

### **Corporate Governance Issue: Internet Privacy and Censorship**

**Current Policy Position:** None

**New Policy Position:** ISS will recommend CASE-BY-CASE on resolutions requesting the disclosure and implementation of Internet privacy and censorship policies and procedures considering:

- The level of disclosure of policies and procedures relating to privacy, freedom of speech, Internet censorship, and government monitoring of the Internet;
- Engagement in dialogue with governments and/or relevant groups with respect to the Internet and the free flow of information;
- The scope of business involvement and of investment in markets that maintain government censorship or monitoring of the Internet;
- The market-specific laws or regulations applicable to Internet censorship or monitoring that may be imposed on the company; and
- The level of controversy or litigation related to the company's international human rights policies and procedures.

**Rationale for Update:** As Internet access expands into countries that may not allow free speech, public concern has mounted over how certain U.S. Internet service providers and technology companies supporting the Internet are managing and disclosing their policies relating to protecting human rights. Specifically, proponents are concerned that these companies may be limiting personal privacy and freedom of speech for users in countries where user monitoring may take place or where free speech may be prosecuted as a crime.

The new policy is generally supportive of disclosure-based resolutions relating to Internet policies, unless the company has already taken proactive steps to address the issue in question. In our evaluation of the merits of the proposal, we will take into account the level of current applicable disclosure on the topic, the level of stakeholder engagement, nature and scope of the company's operations as well as the scope of the proposal, applicable legislation, and the company's past history of controversy and litigation as it pertains to human rights. These guidelines will seek to encourage a disclosure that is not overly costly or burdensome to the company, but includes pertinent information for shareholders to evaluate the potential risks associated with the management of these emerging human rights concerns.

### **Corporate Governance Issue: Operations in High-Risk Markets**

**Current Policy Position:** ISS currently recommends CASE-BY-CASE on proposals requesting that a board committee review and report on the company's financial and reputational risks from its operations in a terrorism-sponsoring state, taking into account the company's current disclosure relating to the nature and scope of business that may be affected by political disruption and the company's compliance with U.S. sanctions and laws.

**New Policy Position:** ISS will recommend CASE-BY-CASE on requests for the company to review and report on the financial and reputation risks associated with operations in "high risk" markets, such as a terrorism-sponsoring state or otherwise, taking into account:

- The nature, purpose, and scope of the operations and business involved that could be affected by social or political disruption;
- Current disclosure of applicable risk assessment(s) and risk management procedures;
- Compliance with U.S. sanctions and laws;
- Consideration of other international policies, standards, and laws; and
- Recent involvement in significant controversies or violations in "high risk" markets.

### **Rationale for Update:**

In recent years, shareholder proponents have filed proposals at companies operating in regions that are politically unstable, including terrorism-sponsoring states, citing concerns over how the investment may, in truth or by perception, support potentially oppressive governments. Operations in these regions, proponents contend, may lead to potential reputational, regulatory, and/or supply chain risks as a result of operational disruptions. Concerned shareholders have requested both a withdrawal of operations in a high-risk market as well as having requested a report on operations in a high-risk market.

Until now, ISS' policy has addressed these proposals with a focus on operations in a terrorism-sponsoring state. Countries determined by the U.S. Secretary of State to have repeatedly provided support for acts of international terrorism are designated pursuant to three laws: the Export Administration Act, the Arms Export

Control Act, and the Foreign Assistance Act. Taken together, these laws can lead to the four categories of sanctions. These provisions may also penalize persons and countries engaging in certain trade with state sponsors of terrorism. Currently, there are five countries designated under these laws: Cuba, Iran, North Korea, Sudan, and Syria.

The updated policy on operations in high-risk markets will continue to address proposals relating to operations in terrorism-sponsoring states, while applying a broader definition of potentially high-risk regions where controversies surround potentially oppressive governments. Further, this amended policy addresses these trends by supporting disclosure-based resolutions more universally, unless the company has already taken proactive steps to address the issue. The policy will encourage disclosure that is not overly costly or burdensome on the company, but includes information for shareholders to evaluate the company's procedures and policies and the potential risks associated with operating in high-risk markets. ISS will not support prescriptive calls for divestment from a particular high-risk market, unless prohibited by U.S. federal law.

### Corporate Governance Issue: Product Safety

**Current Policy Position:** ISS' existing policy is to generally support resolutions requesting that a company disclose its policies related to toxic materials, unless substantial information is already provided by the company. This existing policy works appropriately for manufacturers but falls short of being able to address companies further down the supply chain, notably retailers.

ISS will also continue to recommend on a case-by-case basis when shareholder proponents request that a company evaluate and disclose the potential financial and legal risks associated with utilizing certain chemicals, weighing issues such as: current regulations, recent significant controversy/litigation/fines stemming from toxic chemicals, and the current level of disclosure by the company on this topic. ISS will not support resolutions requiring a company to reformulate its products.

**New Policy Position:** ISS will recommend FOR proposals requesting the company to report on its policies, initiatives/procedures, oversight mechanisms related to toxic materials, including certain product line toxicities, and/or product safety in its supply chain, unless:

- The company already discloses similar information through existing reports or policies such as a Supplier Code of Conduct and/or a sustainability report;
- The company has formally committed to the implementation of a toxic materials and/or product safety and supply chain reporting and monitoring program based on industry norms or similar standards within a specified time frame; and
- The company has not been recently involved in relevant significant controversies or violations.

**Rationale for Update:** ISS evaluates a number of shareholder proposals each season on the issue of toxic chemicals. Proponents have in past years asked companies to phase-out (or evaluate the feasibility of eliminating) certain high profile chemicals, and requested for the use of safer materials. Further, these proposals have also asked for what new initiatives management can or will take to respond to these identified toxicity concerns beyond those initiatives or actions already required by law. Some proponents have requested

reporting on product lines the company sells or produces that may be affected by certain identified toxicity concerns, and a statement of policy options for the company to address the relevant issues. The resolutions also request potential timelines for implementation of these options.

The recent wave of recalls and warnings from products produced in China has ignited concerns about the complex risks associated with product safety and global supply chain management. Companies are increasingly called upon to assume greater responsibility for social and environmental compliance in their supply chain operation. Further, toxic chemicals risks may pose substantial challenges to both manufacturers and downstream customers such as retailers. In the short term, companies may face supply shortages; in the long term, companies may be challenged by persistent supply-chain disruptions and regulatory, legal, and reputational risk. As a result, long-term institutional investors may face significant risk exposure at companies that fail to properly manage product safety in their supply chain.

Consistent with the mounting concerns over product recalls and our client survey results, ISS' toxic chemicals policy has been updated to broaden the reach of the current policy to encompass issues related to product safety and global supply chain management. Companies in the chemical industry and retailers reliant on certain potentially toxic chemicals in their product lines should provide disclosure that enables shareholders to evaluate how the companies are managing toxic chemicals and product safety risks in the supply chain.