

Online Appendix 1: Summary of 2003-2010 ISS Proxy Voting Guidelines¹

ISS voting recommendations on director nominees in uncontested elections focus on four areas: director independence, director competence, board responsiveness and board accountability.

Director independence: ISS recommends withholding votes from inside directors and affiliated outside directors in the following cases: (i) they serve on any of the three key committees (audit, compensation, nominating); (ii) the firm lacks an audit, compensation or nominating committee so that the full board functions as that committee; (iii) the firm lacks a formal nominating committee (even if the board attests that the independent directors fulfill the functions of such a committee); or (iv) the full board is less than majority independent. The ISS voting guidelines include a detailed description of what constitutes an inside director vs. affiliated outside director vs. independent outside director (ISS 2010, pp.14-16). Voting guidelines on director independence were in place throughout the entire sample period (2003-2010), except for (iii) (added in 2007) and (iv), which was added in 2004 in response to new NYSE and NASDAQ listing rules. In 2004, ISS also clarified the definition of inside and affiliated directors to include a broader number of relationships.

Director competence: ISS recommends withholding votes from individual directors who: (i) sit on more than six public company boards; (ii) are CEOs of public firms and sit on the boards of more than two public companies besides their own (withhold only at their outside boards); or (iii) attend less than 75% of the board and committee meetings without a valid excuse (illness, work on behalf of the company, service to the nation, funeral obligations). If the company provides meaningful private or public disclosures explaining the director's absence, ISS will evaluate the information on a case-by-case basis taking into account patterns of absenteeism, degree to which absences were due to an unavoidable conflict and other extraordinary circumstances underlying the director's absence. Voting guideline (iii) was in place throughout the entire sample period (2003-2010), while (i) and (ii) were added, respectively, in 2004 and 2005.

Board responsiveness: ISS recommends withholding votes from the entire board (except new nominees, who will be considered on a case-by-case basis) if: (i) the board failed to act on a shareholder proposal that received approval by a majority of the shares outstanding the previous year; (ii) the board failed to act on a shareholder proposal that received approval by a majority of the shares cast for the previous two consecutive years; (iii) the board failed to act on takeover offers where the majority of the shareholders tendered their shares; or (iv) at the previous board election, any director received more than 50% withhold/against votes of the shares cast and the company has failed to address the issue(s) that caused the high withhold/against vote. Voting guidelines on board responsiveness were in place throughout the entire sample period (2003-2010), except for (iv), which was added in 2005.

Board accountability:

Committee-level (Audit Committee, AC): ISS recommends withholding votes from all AC members if: (i) non-audit fees paid to auditors are excessive;² (ii) the firm receives an adverse opinion on the firm's financial statements from its auditor; or (iii) there is persuasive evidence that the AC entered into an inappropriate indemnification agreement with its auditor that limits the ability of the company, or its shareholders, to pursue legitimate legal recourse against the audit firm. Only voting guideline (i) was in

¹ Source: authors' summary based on the annual ISS Proxy Voting Guidelines released between 2003 and 2010.

² According to the 2010 ISS US Proxy Voting Guidelines, non-audit fees are excessive if they exceed the sum of audit fees, audit-related fees and tax compliance/preparation fees (fees for other tax-related services should be included in the non-audit fees). Examples of fees in each category or what may be excluded from the computation are provided. This policy has been in place since 2003, with the tax/compliance preparation fees included in the calculation since 2006.

place throughout the entire sample period (2003-2010), with (ii) and (iii) added, respectively, in 2009 and 2007. Starting in 2006, ISS may also recommend withholding votes from the AC (and potentially the full board), on a case-by-case basis, in presence of poor accounting practices manifested in fraud, misapplication of GAAP or material weaknesses under Section 404, depending on the severity of the case and the firm's efforts at corrective actions.

Committee-level (Compensation Committee, AC): ISS recommends withholding votes from all CC members (and potentially the full board in egregious cases) if: (i) there is a negative correlation between CEO pay and firm performance; (ii) the company has problematic pay practices; (iii) the firm fails to fulfill the term of a burn rate³ commitment made to shareholders; (iv) the firm fails to submit one-time transfers of stock options to a shareholder vote; or (v) the firm reprices underwater options without shareholder approval (even if allowed in the firm's equity plan).⁴ Voting guideline (i) was put in place in 2004, guidelines (ii)-(iv) in 2006 and (v) in 2007. Starting in 2010, ISS may also recommend withholding votes from all CC members if the board exhibits poor communication and responsiveness to shareholders on compensation-related issues (e.g., failure to respond to majority-supported shareholder proposals on executive pay).

Board-level, anti-takeover-related: ISS recommends withholding votes from the entire Board (except new nominees, who will be considered on a case-by-case basis) if: (i) the company's poison pill has a "dead-hand" or "modified dead-hand" feature; (ii) the board adopts a "long-term" (term >12 months) pill or renews any existing pill (long- or short-term), without shareholder approval;⁵ however, a commitment to put a newly adopted pill to a binding shareholder vote may result in a positive ISS voting recommendation; or, (iii) the board makes a material adverse change to an existing poison pill without shareholder approval. Voting guideline (i) was put in place in 2003, while (ii) was adopted in 2005 (with substantial modifications in 2010)⁶ and (iii) was added in 2010.

Board-level, other governance issues: ISS recommends withholding votes from the entire Board (except new nominees, that will be considered on a case-by-case basis) if: (i) problematic governance provisions

³ Burn rate (or run rate) is a measure of how quickly the firm is using its available share pool and thus how much incremental dilution it is generating by issuing shares for incentive purposes. It is calculated as the total number of shares issued in a given year for incentive purposes scaled by the total number of common shares outstanding.

⁴ The evaluation of the pay-performance link under (i) is based on a qualitative assessment of the historical alignment between CEO pay and stock performance (especially for poorly performing firms) over the past five years, with emphasis on the sources of increases in CEO pay, the composition of pay (i.e. extent of performance-based pay), the quality of disclosures, recent actions taken to increase pay-for-performance, etc. As for (ii), the guidelines provide a long list of examples of problematic pay practices, including certain perks and related tax-gross ups, certain features of change-in-control packages (excise tax gross-ups, single triggers, modified single triggers), multi-year guarantees for non-performance based bonuses, excessive pension benefits, option backdating, poor compensation disclosures, etc. The definition of pay-for-performance disconnect and the list of problematic pay practices have been refined over time and they continued to evolve after 2010 as ISS developed voting guidelines for newly mandated say on pay votes.

⁵ If the board adopts a short-term pill without shareholder approval, ISS may recommend withholding the vote on a case-by-case basis (depending on rationale for adoption, date of adoption relative to next shareholder meeting, past record of accountability to shareholders, etc.).

⁶ ISS' poison pill policy for 2005-2009 was to recommend withholding votes from the entire Board if the board adopts or renews a poison pill without shareholder approval and without commitment to submit it to shareholder approval within 12 months of adoption.

are coupled with sustained poor stock performance relative to peers;⁷ (ii) some directors attended less than 75% of the board and committee meetings and the firm fails to disclose their identity. Some version of voting guideline (i) was essentially in place for the entire sample period (2003-2010), but the definition of poor performance and poor governance has been refined over time. Guideline (ii) was adopted in 2007. Also, starting in 2008, ISS may recommend withholding votes from some/all directors up for election if the board is classified and a director who would otherwise receive a withhold recommendation for a board/committee level governance problem is not up for election.

Extraordinary circumstances: a final provision states that under extraordinary circumstances ISS may recommend withholding votes from directors individually, committee members or the entire board, due to (i) material failures of governance, stewardship or fiduciary responsibilities at the company, (ii) failure to replace management as appropriate; or (iii) egregious actions related to the director(s)' service on other boards that raise substantial doubt about their ability to effectively oversee management and serve the best interests of shareholder at any company. This provision was effectively in place for the entire 2003-2010 sample period (with slightly different language in some years), except for (iii), which was added in 2010.

Key changes after 2010⁸

Committee-level (Compensation Committee): after the introduction of mandatory say on pay votes in 2011, compensation-related concerns are expressed through voting recommendation on say on pay proposals. However, if the say on pay proposal is opposed by more than 30% of the votes cast, ISS may recommend withholding the vote from the CC the subsequent year depending on a series of factors, especially how the board has responded to the concerns behind the say on pay vote.

Board responsiveness: starting in 2014, failure to act on a shareholder proposal that received approval by a majority of the shares cast the previous year is enough to trigger a withhold recommendation. However, the negative recommendation is no longer automatic but on a case-by-case basis, depending on a series of factors (e.g., the rationale given by the board, board engagement with investors, response to the vote, proposal topic and past history, voting support). Also ISS analysts are given some discretion as to whom to hold accountable (e.g., full board vs. nominating/governance committee). Commentators have predicted that this policy change will “shake up boards” (WSJ, 2013).

⁷ Examples of such provisions are a classified board, supermajority voting requirements, dual class structure, inability for shareholders to call special meetings or act by written consent, a non-shareholder approved poison pill and (after 2010), a lack of a majority voting standard for director elections.

⁸ Source: authors' summary based on ISS 2014 U.S. Proxy Voting Summary Guidelines.

Online Appendix 2: Computation of Estimated Rate of Responsiveness (Table 6)

One approach to proxy for responsiveness is to rely on the lack of a repeated ISS withhold. However, this approach would significantly overstate responsiveness in a number of categories. Take the *Poison Pill category* as an example: ISS does not issue a repeated withhold in year $t+1$ even if the firm does not take any action in response to the vote at time t (unless the poison pill has a dead-hand feature, or if the first withhold triggers more than 50% votes withheld). Indeed, unreported analyses show a lack of repeated withhold in 89.5% of the cases in this category, well above the 15.8% actual rate of responsiveness. Another example is the *Lack of Responsiveness* category, where ISS recommends withholdings votes from the entire board for failure to implement a shareholder proposal supported by a majority of the shares cast for the last two years or a majority of the shares outstanding the previous year. For firms that do not implement the proposal, if shareholders do not re-submit it for a vote in year t , ISS will not issue a withhold recommendation in year $t+1$ (without another majority-vote for the proposal in year t , in year $t+1$ the ISS criteria for a withhold will not be met). When we examine each case to determine whether firms implemented the proposal underlying the withhold recommendation, we estimate the rate of responsiveness at 48.9%, again well below the 73.9% suggested by the lack of repeated withhold (unreported). Given the concerns with using the lack of a repeated ISS withhold as a proxy for responsiveness, we adopted the criteria outlined below to estimate the rate of responsiveness reported in the last column of Table 6.

Individual Level – Independence:

Affiliated directors on AC (CC, NC): classified as responsive if the director continues to be classified as affiliated but leaves the committee between years t and $t+1$; classified as not responsive if the director continues to be classified as affiliated but moves to another committee. If the director is no longer classified as affiliated, we classify it alternatively as responsive and not responsive (resulting in an estimated range in the last column of Table 6), since it is not clear whether it is the result of a responsive action that effectively eliminates the “affiliated” nature (e.g., director no longer works for a lender of the firm) or other factors (e.g., ISS changes definition of affiliated). We do not classify (as either responsive or not responsive) cases where the director is no longer affiliated because she has passed the “cooling off” period imposed by ISS (e.g., after a number of years a former executive is no longer considered affiliated)

Insider director on NC: classified as responsive if the director is removed from the nominating committee.
Affiliated/Insider Directors – No Independent NC: classified as responsive if the firm installs an independent NC. Classified as not responsive if the firm does not install an independent NC and the director receives a withhold recommendation in $t+1$ for similar reasons (e.g., affiliated director is reclassified as insider in $t+1$ or vice versa; director receives a withhold recommendation in $t+1$ for general governance failure (of which the lack of independent nominating committee is one element).

Affiliated/Insider Directors – Board Not Independent: classified as responsive if the board changed its independence structure by adding independent directors or replacing affiliated directors with independent directors. All the other cases involve an affiliated director who is no longer defined as affiliated in $t+1$, the reason is unclear (see earlier discussion). Hence, we classify them alternatively as responsive and not responsive (resulting in an estimated range in the last column of Table 6).

Individual Level – Attendance: classified as responsive if the director attends at least 75% the meetings during the subsequent.

Individual Level – Busyness:

Individual Level - Busy: 3+Seats & CEO: classified as responsive if the director either steps down from one or more boards or from the CEO position. However, we classify as not responsive cases where the director steps down from the CEO position (and, thus, does not receive a repeated withhold recommendation as *Busy: 3+Seats & CEO*) while holding on to more than six board seats, resulting in a *Busy: 6+Seats* withhold recommendation in year $t+1$.

Individual Level – Busy: 6+Seats: classified as responsive if the director reduces the number of board memberships to below six. However, we classify as not responsive cases where the director additionally takes on a CEO position and receives a *Busy: 3+Seats & CEO* withhold recommendation in year $t+1$.

Committee Level:

AC & NC Issues: classified as responsive if the firm addresses the underlying concern (all cases in our sample). The most common case in this category is a withhold recommendation for AC members due to excessive auditors' non-audit fees. All the firms receiving this recommendation reduced the auditors' non-audit fees by about 50%, with the new non-audit fees representing on average 30% of total auditors' fees (versus 60% before the negative recommendation).

Compensation Committee Issues – Pay for Performance: classified as responsive if the firm does not get a repeated withhold, since it means that the firm no longer fails the pay-for-performance test used by ISS. To validate the ISS assessment of responsiveness, we examine the change in CEO pay and find that after the year t negative recommendation these firms, on average, reduce CEO pay by 20% (while experiencing stock returns similar to their industry peers). In contrast, the three firms receiving a repeated withhold recommendation increase CEO pay by more than 10% while experiencing below-industry stock returns (and, thus, a worsening of the pay-performance relation, as measured by ISS).

Compensation Committee Issues – Poor Pay Practices: classified as responsive if, based on the ISS report and proxy statement at $t+1$, there is clear evidence that the firm addressed the problem identified in year t . We do not classify as either responsive or not responsive (and exclude from our computation) cases where the withhold recommendation is due to a specific transaction occurring in year t (e.g., a mega grant, some provision of an employment agreement, payments to an outgoing CEO) and that cannot be “undone” in year $t+1$. In these cases, it is not clear how the firm could have “responded” to the withhold recommendation, aside from avoiding similar behavior when presented with similar circumstances in the future.

Board Level:

Lack of Responsiveness: classified as responsive if the firm implemented the shareholder proposal that won a majority of the shares outstanding the previous year or the majority of the votes cast vote in the previous two years. We classify as not responsive the cases where the firm has not implemented the proposal. We do not classify the few cases where we cannot determine whether the firm implemented the proposal or not.

Poison Pill: If the reason for the withhold recommendation is that the board approved a poison pill without shareholder approval (most of the cases in this category), we classify as responsive a firm that by $t+1$ either terminates the poison pill or submits it to shareholder approval; we classify the firm as not responsive if the pill is still in place (without shareholder approval) at $t+1$. If the reason for the withhold recommendation is the presence of a poison pill with a “dead-hand” feature, we classify as responsive a firm that by $t+1$ terminates the poison pill or removes that feature.

For the three sub-categories *Other Issues* in Table 6 (under Individual, Committee and Board Level), we classify as responsive cases where the firm addresses the concern underlying the recommendation and as not responsive the cases where no action is taken. We exclude from the computation of the rate of responsiveness cases where we cannot determine the firm's response.