ISS Proposes 2013 Voting Policy Updates

October 18, 2012

On Tuesday, October 16, Institutional Shareholder Services (ISS) **proposed updates** to its proxy voting guidelines for the 2013 proxy season.

ISS's proposed policy would:

- Recommend voting against boards of directors who do not act on shareholder proposals that were approved by the vote of a majority of shares cast in the prior year;
- Revise ISS's say-on-pay criteria by refining the peer group selection methodology, incorporating "realizable pay" analysis into the qualitative evaluation of pay-for-performance and designating pledging shares as a problematic pay practice;
- Extend the analysis of golden parachute arrangements to existing and legacy arrangements rather than just new or renewed arrangements; and
- Provide for a case-by-case assessment of shareholder proposals to link executive compensation to environmental and social "sustainability metrics."

The proposed updates are open to public comment until October 31, and the final policies are expected to be released in November. While these new policies have not yet been finalized and are subject to revision, it's not too early for public companies to consider how these changes could affect their ISS profile in the upcoming proxy season.

Board Response to Majority-Supported Shareholder Proposals

ISS is considering whether to recommend a vote against or withhold from an entire board of directors (except new nominees, who would be considered case-by-case) if the board failed to act on a shareholder proposal that received the support of a majority of *shares cast* in the previous year. This is a tighter standard than ISS's current approach, which is triggered if the board failed to act on a shareholder proposal that (a) received the support of a majority of the *outstanding shares* the previous year; or (b) received the support of a majority of *shares cast* in the last two out of three years.

The empirical record of the 2012 season suggests that this proposed change would have a real but limited impact. Of the 107 shareholder proposals that received the majority of *votes cast* as of August 2012, some 50% have already been implemented, and in any case, the bulk of those proposals received sufficient support to trigger negative recommendations under the existing policy if those boards fail to act on the proposal. The new policy would have led to a different outcome for 24 companies accounting for 33 of the remaining proposals.

The revised policy would potentially increase the pressure on boards of directors. The prospect of this year's shareholder proposal leading to next year's election contest means that, more than ever, boards will need to take a thoughtful approach toward evaluating the strategic alternatives for proposals that are thought to have a chance of success. If a proposal in fact receives a majority of votes cast, boards will have to carefully consider whether and in what form to implement the proposal and the risks of not taking action, being mindful that ISS at times takes a strict view of what constitutes sufficient implementation.

Say-on-Pay

1. Peer Group for Pay-for-Performance Analysis

ISS's initial compensation screen is based on a quantitative "pay-for-performance" analysis that takes into consideration how a company's CEO compensation ranks within its ISS-selected peer group, as compared with the company's performance ranking within that peer group. ISS's peer group selection methodology has drawn heated criticism in recent years, with many companies finding themselves grouped with companies that they do not consider comparable and with which they do not compete either in business or in the recruiting and retention of talent. The proposed policy would give increased deference to a company's self-selected peer group. Under the proposed methodology, ISS will select from a company's Standard & Poor's Global Industry Classification Standard (GICS) industry group and its self-selected peer group, as well as the GICS group to which those self-selected peers belong. In addition, ISS will place a higher priority on company size *vis-à-vis* its peer group members. With its new methodology, ISS has indicated that it intends to capture groups beyond the company's own classification that may be relevant as comparables, since the prior methodology may not have taken into account a company's multiple business lines, or firms outside the company's GICS group that the company views as a competitor or a pay comparator.

According to ISS's own analysis, under this new method, 42% of companies will have a potential ISS peer group that overlaps at least 50% with their own, and, on average, an ISS peer group will contain 44% of a company's own selected peers. By comparison, the current method results in only 20% of companies having a potential ISS peer group that overlaps at least 50% of their own peer group. In addition, ISS says that under its new methodology, it expects over 90% of peer groups to maintain the subject company within 20% of the peer group median size by revenue (as opposed to 82% under the prior methodology). But ISS would continue to have discretion in determining company peer group composition. As a result, we would expect that during the 2013 proxy season, it may be difficult for companies to predict the composition of their ISS-selected peer group against which their crucial pay-for-performance evaluation is conducted.

ISS requests comments on whether there are additional or alternative ways that ISS should use the company's self-selected peer group, what size range should be used for peer group determination and what other factors should be considered in peer group construction for the pay-for-performance evaluation.

2. Realizable Pay Analysis as a Qualitative Factor

ISS assesses pay-for-performance first on a quantitative basis and then, for companies that fail this initial screen, on a qualitative basis.[1] The pay-for-performance analysis is conducted using the company's reported "grant-date pay" levels, or compensation amounts as they are required to be disclosed in the summary compensation table under the SEC rules. The ISS update would, for large cap companies, incorporate a comparison of "realizable pay" to grant-date compensation into the qualitative analysis. "Realizable pay" for ISS's purposes would consist of "the sum of relevant cash and equity-based grants and awards made during a specified performance period being measured, based on equity award values for actual earned awards, or target values for ongoing awards, calculated using the stock price at the end of the performance measurement period." Accordingly, realizable pay would account for increases or

[1] At the recent National Association of Stock Plan Professionals' (NASPP) conference, Carol Bowie, an ISS representative, noted that almost half of companies that did not meet ISS's quantitative assessment nonetheless still received favorable ISS recommendations, demonstrating the importance of the qualitative factors.

decreases in the company's stock price over the course of the performance period. ISS's definition of realizable pay does not appear to contemplate excluding unvested or otherwise unearned awards in their entirety. Earned awards would be calculated at their actual value, and awards that have not yet been earned would be valued based on their target levels (but using the actual company stock price at the end of the performance period). Freezing the analysis at the grant date means that ISS does not take into account subsequent stock price movements, performance vesting results and other factors that will determine the actual value of equity awards.

The incorporation of realizable pay in the qualitative analysis follows the trend of incorporating discussions regarding "realizable" or "realized" pay in company proxy disclosure. According to a recent analysis conducted by *The Wall Street Journal*, at least 228 companies mentioned realizable or realized pay in their proxy statements in 2012, as compared with 119 in 2011.[2] The methodologies used to calculate realizable or realized pay in these recent proxy disclosure discussions have not been uniform, including with respect to whether or not to count unvested awards or unexercised stock options as realizable or realized pay.

Companies may want to attempt to analyze their realizable pay levels using ISS's definition to determine how this metric would affect ISS's qualitative assessment of the company, though the details of exactly how ISS would perform the calculation remain unclear. ISS also does not specify how it would use the realizable pay comparison in its qualitative analysis, but it notes that realizable pay can cut both ways, mitigating concerns for some companies while exacerbating them for others.

ISS requests comments on the definition of realizable pay, how to value stock options (*e.g.*, based on intrinsic or Black-Scholes value) and the appropriate measurement period for realizable pay.

3. Pledging Shares as a Problematic Pay Practice

The proposed updates would add the pledging of company stock to ISS's list of generally problematic pay practices (which currently includes practices such as repricing underwater options without shareholder approval, providing excessive perquisites or tax gross-ups, and providing for excessive or single-trigger change in control payments). ISS notes that, according to a recent study, executives and/or directors have pledged company shares (either for margin accounts or other loans) at approximately 15% of companies on the Russell 3000 Index, with pledged shares at some companies exceeding 50% of the company's total market value.[3]

The ISS proposal is unclear as to whether pledging would be deemed problematic in all cases, or if there would be a materiality threshold. The means by which companies would implement a pledging prohibition or limit is also unclear.

ISS asks for comments on what level of pledging of company stock would cause investor concern; whether pledging is of significant enough concern to warrant voting action relating to say-on-pay proposals, or on board or committee members; what remedial actions on pledging might address concerns; and any other factors that should be considered by investors.

---

[2] Emily Chasan, *Executive Pay Gets a New Spin*, THE WALL STREET JOURNAL, September 25, 2012 at B1.

[3] The study cited by ISS was conducted by its affiliated MSCI company, Center for Financial Research and Analysis (CFRA), *Review of Pledged Insider Pledged Share Disclosure*, May 17, 2012.

Say-on-Golden Parachutes

ISS's proposed policy recommends that investors vote on a case-by-case basis on golden parachute proposals, "including consideration of existing change-in-control arrangements maintained with named executive officers, rather than focusing primarily on new or extended arrangements." The updated policy notes that recent amendments that incorporate problematic features will carry more weight in the analysis, but the presence of multiple legacy problematic features will also be scrutinized.

ISS requests comments regarding whether investors would differentiate between new and existing arrangements when evaluating a say-on-golden parachute proposal, whether the number of problematic features would be a consideration in the analysis, and other factors that should be considered in the analysis.

Proposals to Link Sustainability Metrics to Executive Compensation

ISS has proposed changes to its existing policy on shareholder proposals to link executive compensation to sustainability (*i.e.,* environmental and social) criteria, otherwise known as "sustainability metrics." ISS notes that shareholder proposals to incorporate sustainable metrics into executive pay have become more common in recent years—particularly in the oil and gas industry and other sectors that face significant environmental issues.

ISS's policy until now has generally been to recommend against these proposals. Under the updated policy ISS would make recommendations on a case-by-case basis depending on:

- Whether the company has significant and/or persistent controversies or violations regarding social and/or environmental issues;
- Whether the company has management systems and oversight mechanisms in place regarding its social and environmental performance;
- The degree to which industry peers have incorporated similar nonfinancial performance criteria in their executive compensation practices; and
- The company's current level of disclosure regarding its environmental and social performance.

In proposing this update, ISS notes that the incorporation of social considerations in the analysis of a company's performance is an evolving issue and has become more commonplace in certain industries.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Cynthia Akard	**650 752 2045**	cynthia.akard@davispolk.com
Ning Chiu	**212 450 4908**	ning.chiu@davispolk.com
Jeffrey P. Crandall	**212 450 4880**	jeffrey.crandall@davispolk.com
Edmond T. FitzGerald	**212 450 4644**	edmond.fitzgerald@davispolk.com
William M. Kelly	**650 752 2003**	william.kelly@davispolk.com
Kyoko Takahashi Lin	**212 450 4706**	kyoko.lin@davispolk.com
Jean M. McLoughlin	**212 450 4416**	jean.mcloughlin@davispolk.com
Richard J. Sandler	**212 450 4224**	richard.sandler@davispolk.com
Veronica M. Wissel	**212 450 4794**	veronica.wissel@davispolk.com

Any U.S. federal tax advice contained in this communication (including any attachments) is not intended to be used, and cannot be used, to avoid penalties under the Internal Revenue Code or to promote, market or recommend any transaction or matter addressed herein.
