ISS Issues Final 2013 Voting Policy Updates

November 20, 2012

On November 16, 2012, Institutional Shareholder Services issued its final updates to its **proxy voting** guidelines for the 2013 proxy season. The key items of change from last year's guidelines are that ISS:

- Recommends voting against boards of directors that do not act on shareholder proposals that were approved by the vote of a majority of shares cast in the prior year, beginning in 2014;
- Designates "significant" pledging, and any hedging, of the issuer's stock by directors and executives as failures of risk oversight that may (or, in the case of hedging, will) warrant recommending a vote against individual directors, committee members or the entire board of directors;
- Revises its say-on-pay analysis to refine the peer group selection methodology and, at least for large-cap companies, incorporates a "realizable pay" analysis into the qualitative evaluation of pay-for-performance;
- Extends the say-on-golden parachute analysis to existing and legacy arrangements, as well as new or renewed arrangements; and
- Assesses, on a case-by-case basis, shareholder proposals to link executive compensation to environmental and social metrics.

The final policy also makes other minor changes to ISS's positions on director elections.

These new policies will be effective for companies holding their annual shareholder meetings on or after February 1, 2013, with the exception of the board response to shareholder proposals, which is effective for annual meetings beginning in 2014. ISS indicated that it will release FAQs on the final policy in December 2012.

Board Response to Majority-Supported Shareholder Proposals

Starting with annual meetings in 2014, ISS will recommend a vote against (or withhold from) an entire board of directors, committee members or individual directors, if the board has failed to act on a shareholder proposal that received the support of a majority of *shares cast* in the previous year. This is a more stringent standard than ISS's current approach, which is triggered if the board fails to act on a shareholder proposal that (i) received the support of a majority of the *outstanding shares* in the previous year; or (ii) received the support of a majority of *shares cast* in the last two out of three years.

The final policy is substantially similar to the policy proposed in October, with some key differences. First, it does not begin to apply until 2014 annual meetings (*i.e.*, with respect to shareholder proposals that receive a majority of votes cast on 2013 ballots). Second, the policy provides ISS with the flexibility to target specific directors or committee members rather than recommending against (or withhold from) the entire board. In addition, the policy indicates that ISS will review board responses that are considered less than full implementation of the proposal on a case-by-case basis. ISS has indicated that it will consider the following factors:

- The proposal's subject matter;
- The level of support for and opposition against the proposal in prior meetings;
- Disclosed shareholder outreach efforts;
- Board actions taken to respond to its engagement with shareholders;

- The continuation of the underlying issue as a voting item; and
- Other factors as appropriate.

The delay in implementation of the revised policy until the 2014 proxy season is consistent with comment letters provided by **Davis Polk** and others, as is the possibility that less than full implementation of the shareholder proposal should be considered responsive under certain circumstances. However, there is a great deal of uncertainty as to how this policy will be applied.

Pledging and Hedging Shares

The final policy takes a strong stand against pledging and hedging transactions by directors and executive officers, and takes the position that a failure to prohibit hedging or “significant” pledging is a sign of a failure of board risk oversight and governance (as opposed to a consideration in the say-on-pay analysis as was suggested in ISS’s proposed policy). ISS’s policy is that *any* amount of hedging of company stock by directors or executive officers will be deemed a problematic practice that *will* warrant a negative voting recommendation.

With respect to companies who have directors or executives who have pledged company stock, ISS *may* issue a negative voting recommendation and will consider the following factors:

- Whether the company’s proxy statement includes an anti-pledging policy that prohibits future pledging activity;
- The magnitude of aggregate pledged shares vis-à-vis total shares outstanding, market value or trading volume;
- The disclosure of progress (or lack of progress) in reducing the amount of aggregate pledged shares over time;
- Proxy disclosure that shares subject to stock ownership and holding requirements do not include pledged shares; and
- Other unspecified factors.

ISS’s position on these issues is that hedging results in a misalignment between the hedging executive or director and shareholders, and that pledging company stock as collateral for a loan is not a responsible use of equity and may have a detrimental impact on shareholders if the executive or director is forced to sell the pledged shares. The tide against hedging and pledging is rising, placing increased pressure on boards to address the issue at a policy level and not to wait for the SEC’s Dodd-Frank rules on hedging policies.

Pay-for-Performance Peer Group Selection

The final policy implements the proposed changes to ISS’s methodology for selecting a company’s peer group for purposes of ISS’s pay-for-performance analysis. The ISS peer group selection process is critical to companies, because ISS’s say-on-pay analysis is initially based on a quantitative “pay-for-performance” screen[1] that takes into consideration how a company’s CEO compensation and how company performance ranks within its ISS-selected peer group.

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[1] The quantitative screen examines a company’s CEO pay levels, measured at the grant-date pay levels, and total shareholder return, as compared with the CEO pay and total shareholder return of the company’s ISS-selected peer group. The quantitative screen also measures trends in CEO pay, as compared with the company’s annualized total shareholder return over the last five years.

Under the new methodology, ISS will select 14 to 24 peers from the company's Standard & Poor's Global Industry Classification Standard (GICS) industry group, as well as the GICS industry groups of the company's self-selected benchmarking peer group in order to choose peers more closely aligned by industry. ISS indicates that it will focus on the eight-digit GICS sub-industry group, which is the most narrow GICS classification, rather than the broader two-digit sector group. ISS indicates that it will prioritize those peers that:

- would maintain the company near the median of the peer group in terms of size, based on market capitalization and revenue (or assets for certain financial firms);
- are in the company's self-selected peer group; and
- have selected the company as a peer.

Whether or not the new methodology will in fact result in ISS peer group selections that more closely resemble companies' self-selected peer groups remains to be seen. While it may be possible for companies to review their own GICS groups and the GICS groups of their self-selected peers, which companies will be selected as peers by ISS remains unclear.

Realizable Pay Analysis as a Qualitative Factor

ISS also included in the final policy its proposal to incorporate a comparison of "realizable pay" to grant-date pay into its qualitative evaluation, which is the second step in ISS's say-on-pay analysis for companies that demonstrate significant pay-for-performance misalignment. Large-cap companies will have "realizable pay" included in their research reports. "Realizable pay" for ISS's purposes will 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." Stock options and stock appreciation rights will be revalued using the remaining term and updated assumptions using a Black-Scholes option pricing model. Accordingly, realizable pay would account for increases or decreases in the company's stock price over the course of the performance period.

Under current ISS policy, qualitative factors include the ratio of performance-to-time vesting equity awards, the overall ratio of performance-based compensation, the completeness of company disclosure and rigor of performance goals, the company's peer group benchmarking practices, the absolute results of financial and operational metrics and such results relative to peers, special circumstances and other factors. The addition of realizable pay to this list would permit ISS to also consider any anomalies between grant-date pay and "realizable pay." ISS does not specify how it would use the realizable pay comparison in its qualitative analysis, but it notes that realizable pay could mitigate or exacerbate compensation concerns.

Say-on-Golden Parachutes

Like the proposed policy, ISS's final policy amends its approach to recommendations on golden parachute proposals to include consideration of legacy features in change in control packages, rather than focusing primarily on recent amendments to change in control arrangements. Under the new policy, ISS identifies the following features that may result in a recommendation against a say-on-golden-parachute vote:

- Single- or modified single-trigger cash severance;
- Single-trigger acceleration of unvested equity awards;
- Excess cash severance (*i.e.*, exceeding three times base salary and bonus);
- Excise tax gross-ups that have been triggered and become payable (as opposed to a provision to provide excise tax gross-ups);

- Excessive golden parachute payments (on an absolute basis or as a percentage of transaction equity value);
- Recent amendments that incorporate any problematic features (such as those listed above) or recent actions (such as extraordinary equity grants) that may make packages so attractive as to influence merger agreements that may not be in the best interests of shareholders; and
- The company's assertion that a proposed transaction is conditioned on shareholder approval of the golden parachute advisory vote.

ISS 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. The update further affirms ISS's disfavor of excessive golden parachute payments, single-trigger vesting of equity and cash payments on a change in control and excise tax gross-ups.

Proposals Relating to Social and Environmental Issues

ISS finalized its 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's policy until now has generally been to recommend against these proposals. Under the updated policy, ISS will 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.

ISS also made some revisions to its existing policy on evaluating social and environmental shareholder proposals generally, by adopting an overall principle that voting recommendations will focus on how the proposal may enhance or protect shareholder value either in the short or long term. Considerations will include whether the issues are better dealt with through regulation, the company's existing response as compared to its industry, and whether the proposal is unduly burdensome.

Other Policy Updates

The final policy also included several other clarifying items that were not discussed in the proposed updates, including the following:

- ISS will continue to recommend a vote against or withhold from directors who attend less than 75% of their board and committee meetings for the period for which they have served, unless their absence, as clearly disclosed in the proxy, is due to medical issues/illness, family emergencies or, if the board held three or fewer meetings, the director missed only one meeting. This is similar to ISS's existing policy, but further makes clear that poor disclosure alone could warrant a negative recommendation.
- The final policy revises ISS's position on "overboarded directors" to clarify that any subsidiary company that is publicly traded will count toward the limit on any director sitting on more than six public company boards (or CEOs of public companies sitting on more than two public company boards besides their own). Previously, if a subsidiary was 20% or more owned by the parent, both boards were counted as a single board for purposes of the "overboarding" limits.

- ISS has streamlined its categorization of directors as "inside directors," "affiliated outside directors" or "independent outside directors." For example, there is an exception for interim service by a director as a CEO, which will now also apply to other offices (*e.g.*, interim CFO).
- ISS made some clarifying changes to its policy on recommendations relating to a company's lobbying activities. It does not appear that this policy is being changed substantively.

Conclusion

In general, ISS's final policy for 2013 is largely consistent with its proposals released in October, although ISS appears responsive to some issuers' concerns as expressed in the comment letters. The real impact remains to be seen in the implementation of the final policy as companies head into the 2013 proxy season.

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.

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