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## ISS Publishes 2013 Draft Policies; Requests Comments by October 31, 2012

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On October 16, 2012, Institutional Shareholder Services Inc. (“ISS”) published its draft policies for the 2013 proxy season (the “Draft Policies”). The US compensation-related Draft Policies address: (i) management say-on-pay proposals; (ii) say on golden parachute proposals; (iii) environmental and social non-financial performance compensation-related proposals; and, indirectly, (iv) board response to majority-supported shareholder proposals. The comment period closes on October 31, 2012 and ISS will publish comments as it receives them. ISS’s final 2013 US and international policy updates are expected to be released on or around November 15, 2012 and the Global Policy Summary and Concise Guidelines in December.

### Management Say-On-Pay Proposals

**Proposed Changes.** ISS’s general pay-for-performance alignment evaluation methodology would generally remain the same, with the following proposed modifications:

- A company’s self-selected benchmarking peer group would be used as an input to ISS’s peer group methodology, but ISS would otherwise continue to select peer groups based on company size and market capitalization.
- A comparison of *realizable pay*<sup>1</sup> to the grant date pay disclosed in the summary compensation table would be incorporated into ISS’s evaluation of pay-for-performance alignment.
- The failure to maintain a policy prohibiting the pledging of company stock would be an additional factor in ISS’s evaluation of problematic pay practices that could lead to negative management say-on-pay recommendations.

<sup>1</sup> The Draft Policies define realizable pay as “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.” ISS is specifically requesting comment on this definition.

**Peer Groups.** The Draft Policies set out a methodology for identifying peer groups that focuses on identifying companies that are reasonably similar in terms of industry profile, size and market capitalization. However, the methodology would incorporate information from a company's benchmarking peer group (as disclosed in its proxy statement) and the GICS groups represented in the benchmarking peer group to identify and prioritize ISS's peer group. If the Draft Policies are implemented as proposed, the average company would have more than 80% of its ISS peers drawn from the company's 8-digit GICS group or the 8-digit GICS groups of the company's benchmarking group. The remaining peers would be selected from the 4- or 6- digit GICS groups. The methodology would prioritize peers that include the company near the median of the peer group, that are in the company's peer group, and that have also chosen the company as a peer. ISS would also include slightly relaxed size requirements for very small and very large companies.

Under current ISS policy, only 40% of the peers are drawn from the company's 8-digit GICS group and 12% are drawn from the company's 2-digit GICS group. ISS noted that its current peer group methodology may not reflect multiple business lines in which companies operate. This sometimes resulted in a company's competitors being omitted from their ISS peer group and other companies being included.

**Comparison of Realizable Pay to Grant Date Pay.** Under current ISS policy, if the pay-for-performance analysis demonstrates a significant unsatisfactory long-term pay-for-performance alignment, ISS looks to specified qualitative factors<sup>2</sup> to determine how various pay elements encourage or undermine long-term value creation and alignment with shareholder interests. The Draft Policies would add an additional factor that compares realizable pay to grant date pay for large cap companies. ISS noted that in the 2012 proxy season, more companies disclosed alternative measures of realized or realizable pay in the compensation discussion and analysis section of their proxy statements, in addition to the grant date pay disclosure required in the proxy tables.

**Pledging.** The Draft Policies would add pledging of company stock to the list of problematic pay practices that carry significant weight in ISS's consideration of a company's overall pay program. ISS noted that, although pledging policies are not directly tied to compensation, a substantial amount of shares owned by directors and executives are delivered under compensation programs, making say-on-pay proposals a reasonable mechanism for shareholders to object to pledging practices.

<sup>2</sup> The qualitative factors include: (i) the ratio of performance- to time-based equity awards; (ii) the overall ratio of performance-based compensation; (iii) the completeness of disclosure and rigor of performance goals; (iv) the company's peer group benchmarking practices; (v) the actual results of financial/operational metrics, such as growth in revenue, profit, cash flow, etc., both absolute and relative to peers; (vi) special circumstances related to, for example, a new CEO in the prior fiscal year or anomalous equity grant practices (e.g., biannual awards); and (vii) any other factors deemed relevant.

## Say on Golden Parachute Proposals

The Draft Policies would update ISS's current policy on say on golden parachute proposals, pursuant to which ISS would:

- Analyze existing change in control arrangements maintained with named executive officers, rather than focusing only on new or extended arrangements; and
- Place further scrutiny on existing change in control agreements that contain more than one problematic pay practice.<sup>3</sup>

ISS noted that in 2012, of the proposals submitted after July 2011, approximately 81% of say on golden parachute proposals passed, while the underlying transactions garnered more than 95% support. Prior ISS surveys also indicated that a majority of investors do not favor single trigger equity vesting on a change in control.

## Environmental and Social Non-Financial Performance Compensation-Related Proposals

ISS has not previously supported shareholder proposals on environmental or social non-financial performance measures. The Draft Policies would require a case-by-case analysis on these proposals, generally considering the specific factors currently used (modifying the "significant and persistent" controversies or violations factor to "significant and/or persistent"). ISS noted that initiatives like the UN Principles for Responsible Investment<sup>4</sup> are gaining support from institutional investors. Requiring a case-by-case analysis allows ISS policy to incorporate developments on an evolving issue.

## Board Response to Majority-Supported Shareholder Proposals

Under current policies, ISS recommends that shareholders vote either "against" or "withhold" from the entire board of directors, other than new nominees who are considered case-by-case, if the board failed to act on a shareholder proposal that either: (i) received the support of a majority of shares *outstanding* in the previous year, or (ii) received the support of a majority of shares *cast* in the last year and one of the two previous years. The Draft Policies would have ISS recommend either "against" or "withhold" if the board failed to act on a shareholder proposal that received the support of a majority of shares *cast* in the previous year.

<sup>3</sup> Problematic pay practices include: (i) single or modified single trigger cash severance; (ii) single trigger acceleration of unvested equity awards; (iii) excessive cash severance (greater than 3 times base salary and bonus); (iv) excise tax gross-ups triggered and payable (as opposed to a provision to provide excise tax gross-ups); (v) excessive golden parachute payments (on an absolute basis or as a percentage of transaction equity value); (vi) recent amendments that incorporate any problematic features (such as (i) through (v)) 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; or (vii) the company's assertion that a proposed transaction is conditioned on shareholder approval of the golden parachute advisory vote.

<sup>4</sup> The UN Principles for Responsible Investment is an initiative and a set of aspirational and voluntary guidelines for investors wishing to address environmental, social and corporate governance issues.

## Conclusion

Those interested in commenting on the Draft Policies only have until October 31, 2012 to get their comments to ISS. It will be interesting to see how changes to management say-on-pay proposal recommendations, combined with enhanced recommendations against board members who do not implement changes to their pay practices following a negative say-on-pay vote, will affect the 2013 proxy season.

This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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