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ISS Publishes 2013 US Corporate Governance Policy Updates

On November 16, 2012, Institutional Shareholder Services Inc. (“ISS”) released its US policy updates for the 2013 proxy season (the “2013 Policies”), having received comments to its draft policies released October 16, 2012.¹ The most significant 2013 Policies contain updates in respect of the following matters: (i) hedging and pledging of company stock; (ii) board responsiveness to majority-supported shareholder proposals; (iii) overboarded directors; (iv) executive pay-for-performance evaluation; (v) say on golden parachute proposals; and (vi) environmental, social and governance non-financial performance compensation-related proposals. The 2013 Policies will generally be effective for shareholder meetings of publicly-traded companies held on or after February 1, 2013.

The 2013 Policies also contain updates in respect of (a) the ISS voting policy applicable to directors attending fewer than 75% of board or committee meetings; (b) the definition of “Inside Director”; (c) the ISS voting policy applicable to social and environmental shareholder proposals; and (d) the ISS voting policy applicable to shareholder proposals concerning lobbying activities.

Hedging and Pledging of Company Stock

Under current ISS Policies (the “2012 Policies”), ISS may, in extraordinary circumstances, recommend that shareholders vote either “against” or “withhold” from individual directors or the entire board due to material failures of governance, stewardship, risk oversight or fiduciary responsibilities at the company. The 2013 Policies make explicit that the hedging of company stock or significant pledging of company stock by directors and executives will be considered failures of risk oversight for purposes of this policy. ISS stated in the 2013 Policies that any amount of hedging will be considered “a problematic practice warranting a negative voting recommendation” and that it will consider a number of factors in determining vote recommendations for the election of directors at companies that currently have executives or directors with pledged company stock (including whether the company disclosed in its proxy statement an anti-pledging policy prohibiting future activity and the magnitude of pledged shares compared to total shares outstanding). ISS also noted its view that

¹ The 2013 Policies can be found on the ISS website at http://www.issgovernance.com/policy/2013/policy_information. Our client publication summarizing ISS’s draft policies can be found [here](#).

hedging severs the alignment of executive and director interests with the interests of shareholders that is intended to be created by director and executive ownership of company stock, and that pledging of company stock as collateral for a loan is not a responsible use of equity because of the detrimental impact to shareholders that can result if a director or executive is forced to sell stock, for example, to meet a margin call.

Board Response to Majority-Supported Shareholder Proposals

Under the 2012 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 2013 Policies will give directors less time to respond to shareholder proposals by providing that ISS will issue a negative vote recommendation if the board fails to act on a shareholder proposal that received the support of a majority of the shares cast in the previous year. This change in policy is being implemented on a transitional basis, however, and will only become effective beginning with shareholder proposals appearing on companies’ ballots in 2013 (meaning that the updated ISS voting policy will become effective for the 2014 proxy season). The current policy will continue to apply to ISS vote recommendations issued for the upcoming 2013 proxy season, supplemented by guidance set forth in the 2013 Policies concerning the sufficiency of a company’s action in response to a majority-supported shareholder proposal.² In addition, the 2013 Policies give ISS the flexibility, effective in the 2013 proxy season, to recommend against individual directors or committee members, rather than against the entire board. ISS notes that a recent ISS survey shows that 86% of institutional investors expect that the board should implement a shareholder proposal that receives support from a majority of shares cast in the previous year, and that 47% of the issuers responding to the same survey concurred.

Overboarded Directors

Under the 2012 Policies, ISS recommends that shareholders vote either “against” or “withhold” from individual directors who (i) sit on more than six public company boards, or (ii) are CEOs of public companies who sit on the boards of more than two public companies besides their own (the negative vote recommendation is only with respect to outside boards). Under the 2012 Policies, ISS does not count service by a director on the board of a parent as well as the board of its publicly-traded subsidiary (where ownership is 20% or higher) as serving on two separate boards. The 2013 Policies change this approach and provide that service by a parent director on any non-controlled (i.e., where ownership is less than 50%) subsidiary board that is publicly-traded will be counted as service on two separate boards.

² Under the 2013 Policies, responding to a shareholder proposal will generally mean “either full implementation of the proposal or, if the matter requires a vote by shareholders, a management proposal on the next annual ballot to implement the proposal.” ISS will consider on a case-by-case basis responses that involve less than full implementation, taking into account: (i) the subject matter of the proposal; (ii) the level of support and opposition provided to the resolution in past meetings; (iii) disclosed outreach efforts by the board to shareholders in the wake of the vote; (iv) actions taken by the board in response to its engagement with shareholders; (v) the continuation of the underlying issue as a voting item on the ballot (as either shareholder or management proposals); and (vi) other factors as appropriate. ISS noted that it will be releasing an FAQ document in December 2012 with further guidance related to this matter.

Executive Pay Evaluation: Advisory Votes on Executive Compensation

ISS's general pay-for-performance alignment evaluation methodology generally remains the same, with the following key changes:

- A company's self-selected benchmarking peer group will be used as an input to ISS's peer group methodology, but ISS will otherwise continue to select peer groups based on company size and market capitalization.
- A comparison of *realizable pay* to the grant date pay disclosed in the summary compensation table will potentially be incorporated into ISS's evaluation of pay-for-performance alignment for large cap companies.

Peer Groups. The 2013 Policies set forth a new methodology for identifying peer groups that focuses on identifying companies that are reasonably similar in terms of industry profile, size and market capitalization, while granting greater deference to a company's self-selected peers.

Under the 2012 Policies, a company's peer group was generally comprised of 14-24 companies in the company's Standard & Poor's Global Industry Classification Standard ("GICS") industry group. Only 40% of the peers under the 2012 methodology were drawn from the company's eight-digit GICS group and 12% were drawn from the company's two-digit GICS group. ISS noted that this methodology did not always reflect multiple business lines in which companies operate, with the result that a company's competitors were sometimes omitted from its ISS peer group. The revised methodology under the 2013 Policies is intended to minimize such omissions.

The methodology set forth in the 2013 Policies incorporates information from both the company's self-selected benchmarking peer group (as disclosed in its proxy statement) and the company's GICS industry group. ISS will prioritize peers that are closest to the company in terms of revenue and industry, as well as those peers with a similar market capitalization. According to an analysis conducted by ISS, under the new methodology, the average company is expected to have more than 80% of its ISS peers drawn from the company's eight-digit GICS group or the eight-digit GICS groups of the company's self-selected benchmarking group. The remaining peers will be selected from the four- or six-digit GICS groups. The new methodology will 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. The new methodology will also include slightly relaxed size requirements, especially for very small and very large companies, and will allow for the use of revenue instead of assets in determining the size of certain financial companies.

Comparison of Realizable Pay to Grant Date Pay. Under the 2012 Policies, if the ISS pay-for-performance analysis demonstrated a significant unsatisfactory long-term pay-for-performance alignment, ISS analyzed specified qualitative factors³ to determine how various pay elements encourage or undermine long-term value creation and alignment with shareholder interests. Under the 2013 Policies, ISS may consider an additional factor that compares realizable pay to grant date pay for large capitalization companies.

"Realizable pay" is intended to reflect how executive pay has been affected by performance. Under the 2013 Policies, realizable pay consists of the sum of cash and equity-based grants and awards made during the specified performance period

³ 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.

being measured, based on equity award values for actual earned awards, or target values for ongoing awards. The calculation will be made using the stock price at the end of the performance measurement period. Stock options and stock appreciation rights will be re-valued using the remaining term and updated assumptions, as of the performance period, using a Black-Scholes option pricing model.

While ISS has not specified how it will use the realizable pay comparison in its qualitative analysis, it notes that the realizable pay analysis may either mitigate or exacerbate pay-for-performance concerns.

Say on Golden Parachute Proposals

The 2013 Policies update ISS's current policy concerning say on golden parachute proposals to provide for the following key modifications:

- ISS will analyze existing change in control arrangements maintained with named executive officers, rather than focusing only on new or extended arrangements;
- ISS will place further scrutiny on existing change in control agreements that contain more than one problematic pay practice;⁴ and
- ISS will focus on excise tax gross-ups that are triggered and payable (as opposed to a provision providing for a gross-up).

ISS noted that under the 2012 Policies, 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, Social and Governance Compensation-Related Proposals

Under the 2012 Policies, ISS generally recommends against shareholder proposals to link, or report on linking, executive compensation to environmental or social non-financial performance measures. The 2013 Policies amend this approach by requiring a case-by-case analysis of these proposals based on certain factors (which have not changed from the 2012 Policies, except that the "significant and persistent controversies or violations" factor has been modified to reference "significant *and/or* persistent controversies or violations"). ISS notes that the incorporation of environmental- and social-related non-financial performance metrics (termed "sustainability" criteria in the 2013 Policies) into executive compensation is becoming commonplace in certain industry sectors, and is increasingly addressed in international investor initiatives like the UN Principles for Responsible Investment.⁵

⁴ 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 three 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.

⁵ 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.

Other Updates in the 2013 Policies

The 2013 Policies contain a number of other clarifications and updates, including (i) recommending a vote against the individual director, instead of the full board, if proxy disclosure is insufficient to determine whether such director attended at least 75% of board and committee meetings; (ii) revising director categorizations to provide that any director named in the summary compensation table, including any current interim officer, is an inside director, while expanding the exclusion for directors named in the table because they were former interim officers (in the past the exclusion was limited to former interim CEO); (iii) establishing overarching principles for evaluating social and environmental proposals for all markets, with emphasis on how the proposal may enhance or protect shareholder value in either the short or long term; and (iv) in connection with proposals requesting information on a company's lobbying activities, which are considered on a case-by-case basis by ISS, revising the policy to clarify the scope (all types of lobbying activities) and focus (lobbying policies and procedures as well as lobbying activities) to be considered in developing a recommendation.

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.

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

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