



ISS Issues 2013 Corporate Governance Recommendations

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Introduction

Institutional Shareholder Services (ISS) has released its 2013 updates to corporate governance policy, which include some variations from its proposed updates issued mid-October for public comment. In general, the policy updates will be effective for shareholder meetings held on or after February 1, 2013. On December 6, 2012 at 11 a.m. ET, ISS will host a webinar to highlight its updates. Either on that date or thereafter, ISS will also release frequently asked questions to provide additional guidance related to some of the new policies.

Pat McGurn, ISS Special Counsel, spoke on Friday morning immediately after ISS released the new updates at the ABA Shareholder and Investor Relations subcommittee panel, moderated by Squire Sanders. He outlined the highlights of the new policy and offered some helpful commentary to those in attendance; a few of Pat's points are integrated below.

Compensation Updates

Say-on-Pay: Peer Group

In carrying out its pay for performance analysis, ISS previously selected a company's peer group largely based on the company's S&P Global Industry Classification Standard (GICS), selecting 14 to 24 companies with a matching GICS that were reasonably similar in industry profile, size and market capitalization to the particular company. This methodology sometimes did not reflect multiple business lines in which a company operates, resulting in omitting competitors of the company and/or including peers that were not appropriate for performance and pay comparisons.

Moving forward, ISS methodology will now initially focus on an eight-digit GICS to identify peers more closely related within a company's industry. It will also incorporate information from a company's self-selected pay benchmarking peer group to identify and draw peers from the GICS groups represented in the company's self-selected peer group. ISS will prioritize peers that are in the company's GICS peer group, that have chosen the company as a peer and that result in an overall peer group in which the company falls near the median. ISS has also flagged that it will use slightly relaxed size requirements, especially at very large and small companies, and use revenue instead of assets as a reference point for certain financial companies.

For those companies that plan to make adjustments to their self-selected pay benchmarking peer group in 2013, and would like ISS to take those changes into account in its 2013 review of the company, ISS will launch a web portal in December 2012 where companies will be able to update their peer groups for ISS purposes. ISS representatives have confirmed that companies' peer group revisions will be maintained in confidence by ISS. Unless otherwise updated by a company, the ISS methodology will incorporate the company's self-selected 2012 peer group.

Say-on-Pay: Realizable Pay Analysis

For large capitalization companies, ISS will add realizable pay to its qualitative evaluation of say-on-pay proposals, in addition to its review of executive compensation as reported in the summary compensation table. "Realizable pay" 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. The revised policy intends to take into account not only the grant-date value of compensation paid to executives, but also the change in value of performance-based awards based on the actual performance of a company's stock. ISS will conduct a multiyear comparison of a company's realizable pay with the performance of the company in efforts to provide multiple views of pay performance. Stock options and stock appreciation rights will be re-valued using the remaining term and updated assumptions, as of the performance period, using the Black-Scholes Option Pricing Model.

Say-on-Golden Parachute Policy

Dodd-Frank requires companies to hold separate shareholder votes on potential golden parachute payments when they seek shareholder approval for mergers, sales and certain other transactions. Historically, ISS has focused primarily on new or extended arrangements in its analysis of a golden parachute "say on pay" vote. Beginning in the 2013 proxy season, ISS will (1) consider existing change-in-control arrangements maintained with named executive officers in making case-by-case recommendations on Say-on-Golden Parachute proposals and (2) place further scrutiny on multiple legacy features that ISS considers problematic in change-in-control agreements. ISS cautioned that a number of features may result in recommendations against these proposals including excessive golden parachute payments, excessive cash severance (which it has described as over three times an executive's base salary and bonus) and conditioning a proposed transaction on shareholder approval of the golden parachute advisory vote.

Board Responsiveness and Director Competence Updates

Pledging Shares as a Problematic Pay Practice

ISS revised its "governance failures" policy to add the significant pledging of company shares by directors and executive officers as loan collateral to its risk oversight factors for recommending a vote "against" or "withheld" from directors individually, committee members or the entire board. ISS will be taking a case-by-case approach in determining whether such pledging rises to a level of serious concern for shareholders. It is anticipated that ISS will focus its energies on outliers and the most egregious cases of share pledging. This change in the policy takes into account the detrimental effect that this practice could potentially have on shareholders where, for example, an executive is required to sell a large amount of stock in order to meet a margin call or pledges his or her shares as a hedging strategy against the poor performance of the company's stock, while maintaining voting rights.

In making its vote recommendation, ISS will consider a number of factors including the presence in a company's proxy statement of an anti-pledging policy that prohibits future pledging activity, the magnitude of aggregate pledged shares in terms of total common shares outstanding, market value or trading volume and the disclosure in the proxy statement that shares subject to stock ownership and holding requirements do not include pledged company stock.

Majority-Supported Shareholder Proposals

Beginning in 2014, ISS will recommend votes "against" or "withheld" from individual directors, committee members or entire boards that fail to act on shareholder proposals that received a majority of votes cast in the previous year. According to ISS, "responding to a shareholder proposal" will generally mean either full implementation of the proposal or a management proposal on the next annual ballot to implement it (with respect to matters that require a vote by shareholders). ISS will be releasing frequently asked questions in December 2012 for further guidance on this subject. This

one-year, votes cast requirement will commence with shareholder proposals appearing on companies' ballots in 2013. It is anticipated that this change in policy approach will only affect a limited number of companies; only two dozen or so would have faced significant changes had it been enacted for the 2012 proxy season.

In the near-term, the ISS policy will remain largely unchanged for the 2013 proxy season, recommending votes "against" or "withheld" from boards that fail to act on shareholder proposals that received the support of a majority of either the shares outstanding in the previous year or the shares cast in the last year and one of the two previous years.

Attendance at Board/Committee Meetings

ISS revised its policy with respect to Board/Committee-meeting attendance to clarify that it will recommend a vote "against" or "withhold" from individual directors who attend less than 75 percent of the aggregate of their board and committee meetings for the period for which they served, unless an acceptable reason (such as medical issues/illness; family emergencies; or missing only one meeting when the total of all meetings is three or fewer) is disclosed in an SEC filing. As a result, this policy will focus on individual director failings instead of the entire board (ISS did not include its originally proposed "entire board" provision). In addition, ISS will also recommend a vote "against" or "withhold" from directors whose attendance is questionable due to unclear and insufficient attendance disclosure, a new consideration that is intended to encourage companies to provide clearer disclosure on director attendance.

Overboarded Directors

ISS will continue to recommend votes "against" or "withhold" from individual directors who sit on more than six public company boards. Further, ISS will now count boards of subsidiary companies that are at least 20 percent owned by the parent and have publicly traded stock as separate boards in this calculus, though subsidiaries that only issue debt will not count as "public" for this purpose. Previously, a parent company and any of its subsidiary companies were considered a single board for purposes of the overboarded provision.

Corporate Governance Updates

Linking Environmental and Social Non-Financial ("Sustainability") Performance Metrics to Executive Compensation

ISS has adjusted its policy in relation to stockholder recommendations to link executive compensation to environmental and social non-financial performance metrics. Instead of generally recommending against these types of proposals, ISS will make its recommendations on a case-by-case basis. In recommending votes on such proposals, ISS will consider: (1) whether a company has significant and/or persistent controversies or violations with respect to social and/or environmental issues; (2) whether a company has management systems and oversight mechanisms in place with respect to its social and environmental performance; (3) the extent to which industry peers have incorporated similar sustainability criteria in their executive compensation practices; and (4) a company's current level of disclosure regarding its environmental and social performance.

Lobbying

In its efforts to clarify the scope and focus of its lobbying policy, ISS will now recommend a vote on a case-by-case basis for proposals requesting information on a company's indirect and grassroots (in addition to direct) lobbying practices and procedures (in addition to lobbying activities). In addition, ISS clarified that its analysis will now address situations where a proposal cites specific public policy issues and not how a company may be affected by public policy issues generally.

Proxy Statement Update Tips

Based on the updated ISS policy, companies may want to consider some additional disclosures in their 2013 proxy statements if they want favorable ISS vote recommendations. In particular, companies should contemplate disclosing whether their shares subject to stock ownership and holding requirements include pledged company stock and/or the existence of an anti-pledging policy, if applicable. In addition, companies may wish to more clearly outline the attendance record of its directors, and provide an explanation (if available) for why a director failed to attend less than 75 percent of the aggregate board and committee meetings.

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