

## ISS Issues 2013 Policy Updates

*If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.*

**Stuart N. Alperin**

New York  
212.735.3920  
stuart.alperin@skadden.com

**Brian V. Breheny**

Washington, D.C.  
202.371.7180  
brian.breheny@skadden.com

**Marc S. Gerber**

Washington, D.C.  
202.371.7233  
marc.gerber@skadden.com

**Richard J. Grossman**

New York  
212.735.2116  
richard.grossman@skadden.com

**Neil M. Leff**

New York  
212.735.3269  
neil.leff@skadden.com

**Regina Olshan**

New York  
212.735.3963  
regina.olshan@skadden.com

**Erica Schohn**

New York  
212.735.2823  
erica.schohn@skadden.com

**Joseph M. Yaffe**

Palo Alto  
650.470.4650  
joseph.yaffe@skadden.com

**Barbara R. Mirza**

Los Angeles  
213.687.5614  
barbara.mirza@skadden.com

\* \* \*

*This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws.*

Four Times Square, New York, NY 10036  
Telephone: 212.735.3000  
**WWW.SKADDEN.COM**

Institutional Shareholder Services (ISS), an influential proxy advisory firm, annually updates the policies that underlie its voting recommendations to its institutional investor clients. On November 16, 2012, ISS issued its policy updates applicable to shareholder meetings occurring on or after February 1, 2013. This memorandum describes the key corporate governance and executive compensation policy updates applicable to publicly traded U.S. companies. The policy updates may be viewed in full at <http://www.issgovernance.com>.

Depending on a company's shareholder base, ISS's recommendations can have a significant impact on the outcome of items submitted to a shareholder vote. Companies should consider the potential impact of the ISS policy updates on their 2013 "Say on Pay" proposals and director elections now, in advance of the 2013 proxy season, and evaluate whether any changes to company practices are advisable.

The most significant changes to ISS's policies, discussed in more detail below, address:

- board responsiveness to majority-supported shareholder proposals;
- the inclusion of hedging and significant pledging of company stock as board oversight failures;
- the counting of subsidiary company boards in the determination of whether a director is "overboarded"; and
- executive compensation matters (including peer group determination, realizable pay and "Say on Golden Parachutes" vote).

### Board Responsiveness to Majority-Supported Shareholder Proposals

Under its existing policy, ISS will recommend "against" or "withhold" votes from an entire board of directors (considering new nominees on a case-by-case basis) if the board failed to act on a shareholder proposal that received the support of (i) a majority of the shares *outstanding* the previous year or (ii) a majority of the votes *cast* in the last year and one of the two previous years. Under ISS's new policy, a majority of votes *cast* at a single meeting will be the trigger for ISS to evaluate a company's response to majority-supported shareholder proposals appearing on companies' ballots in 2013.

In response to ISS's proposal to recommend "against" or "withhold" votes from a board failing to act on a shareholder proposal that received the support of a majority of the votes *cast* in the previous year, many corporate community commenters noted the significance of this change and the difficulty that some companies could face at this stage of their corporate calendars. Many commenters also noted the uncertainty around the ability to vary from the precise terms of a shareholder proposal and whether any variance would constitute a "failure to act."

As a result, ISS's new policy of making negative recommendations where a board fails to act on a shareholder proposal receiving support from a majority of the votes cast in the previous year will apply prospectively and not retroactively. In other words, ISS's new policy will apply in 2014, based on shareholder proposals voted on in 2013. Voting

recommendations for directors in 2013 will apply ISS's prior policy when considering the board's responsiveness to shareholder proposals voted on in 2012.

In addition:

- ISS has added the flexibility to recommend “against” or “withhold” votes against individual members of the board (*e.g.*, committee chairs or members, rather than the full board); and
- ISS provides additional guidance on its examination of the sufficiency of a company's action in response to a majority-supported shareholder proposal.

With respect to ISS's review of a company's responsive action, ISS indicates that responding to a majority-supported shareholder proposal generally will mean either fully implementing the proposal or including a management proposal on the next annual ballot to implement the proposal (in the event the matter requires a shareholder vote). Where a company's response does not involve full implementation of the proposal, ISS will evaluate the response by taking into account:

- the subject matter of the proposal;
- the level of support and opposition provided to the resolution in past meetings;
- disclosed outreach efforts by the board to shareholders in the wake of the shareholder vote;
- actions taken by the board in response to its engagement with shareholders;
- the continuation of the underlying issue as a voting item on the ballot (either as shareholder or management proposals); and
- other factors it considers appropriate.

ISS stated that it will be releasing further guidance on this topic in December 2012.

### **Hedging and Significant Pledging of Company Stock as Board Oversight Failures**

Under its current policy, under “extraordinary circumstances” ISS will recommend “against” or “withhold” votes from directors individually, committee members or the entire board where ISS believes there have been material failures of governance, stewardship, risk oversight or fiduciary responsibilities at the company. The policy update indicates specific examples of risk oversight failures and includes, among other things, hedging of company stock by directors or officers or significant pledging of company stock by these persons.<sup>1</sup>

Under the Dodd-Frank Act, companies eventually will have to make proxy statement disclosure as to whether they have a policy permitting directors and employees to hedge against decreases in company stock. Also, there have been some high profile instances of public company executives having to dispose of company stock to satisfy margin calls. To the extent that companies have adopted policies in these areas, those policies may discourage but ultimately permit hedging and/or pledging of shares. Accordingly, ISS's new policy goes beyond legal or regulatory requirements and beyond policies that many companies have adopted when considering their own circumstances.

In its update, ISS stated that “any amount of hedging will be considered a problematic practice warranting a negative voting recommendation.” In the case of companies that currently have executives

<sup>1</sup> Other examples of risk oversight failures include bribery; large or serial fines or sanctions from regulatory bodies; and significant adverse legal judgments or settlements.

or directors with pledged company stock (which would include shares held in margin accounts), ISS will consider the following factors in determining vote recommendations for director elections:

- the presence in the company’s proxy statement of an antipledging policy that prohibits future pledging activity;
- the magnitude of aggregate pledged shares in terms of total common shares outstanding or market value or trading volume;
- disclosure of progress or lack thereof in reducing the magnitude of aggregate pledged shares over time;
- disclosure in the proxy statement that shares subject to stock ownership and holding requirements do not include pledged shares; and
- any other factors it considers relevant.

### **Overboarded Directors**

ISS recommends “against” or “withhold” votes for “overboarded” directors. It considers directors overboarded if they:

- sit on more than six public company boards; or
- are the CEO of a public company who sits on the boards of more than two public companies besides their own.

ISS currently counts publicly traded subsidiaries owned 20% or more by the parent company as one board with the parent company. Under its new policy, ISS will count all subsidiaries with publicly traded stock as separate companies. Subsidiaries with only publicly traded debt will not count separately from their corporate parents. Mutual funds will continue to be rolled up to the mutual fund families (with one family counting as one board). Nonprofit organizations, universities, advisory boards and private companies also will continue not to be counted. In the case of CEOs, the ISS negative recommendation does not apply to the CEO’s own board. Similarly, ISS will not recommend against the CEO at any of the CEO’s company’s subsidiaries that are greater than 50% owned by the parent company.

### **Executive Compensation**

#### ***Peer Group Determination***

During the 2012 proxy season, many companies expressed concern about the ISS peer group selection process, which sometimes resulted in the peer group chosen by ISS having only one or two companies in common with the peer group selected by the company in question. In order to reduce the degree of this divergence, ISS has revised its methodology as follows:

- ISS will take into account a company’s self-selected peer group when choosing companies for the ISS peer group, in order to identify additional Global Industry Classification Standard (GICS) codes that may be relevant in determining the ISS peer group. ISS has stated that while under the 2012 methodology only 20% of companies had an ISS peer group that overlapped with the self-selected peer group by at least 50%, under the 2013 methodology 42% of companies will have such an overlap, and the average ISS peer group will contain 44% of a company’s self-selected peers. ISS has stated that the methodology will prioritize peers that maintain the company near the median of the peer group, are in the company’s peer group, and that have chosen the company as a peer.

- In addition, while ISS has indicated that it will continue to utilize the GICS system to choose peers, its updated selection process will focus initially on the 8-digit GICS sub-code level in order to more precisely target the industry of potential peer group members, such that the average company will have more than 80% of its peers selected from its 8-digit GICS group or the 8-digit GICS groups of its self-selected peers. No peers will be chosen based on the more general 2-digit GICS code. By contrast, under the methodology used by ISS in 2012, only 40% of peers were chosen based on an 8-digit GICS code, while 12% were chosen based on a 2-digit code.
- ISS has indicated that it will slightly relax its requirements relating to size of companies considered, particularly when constructing peer groups for very large and very small companies, and will use assets instead of revenue for certain financial companies. ISS notes that while under the 2012 methodology 82% of peer groups resulted in the subject company falling within 20% of the peer group median size by revenue, that number rises to 90% under the 2013 methodology.

These changes are likely to result in a decrease in the number of companies whose ISS-selected peer group contains companies with which the company does not compete for market share or talent. We will be monitoring supplemental filings closely in 2013 to determine whether any companies have negative reactions to the ISS peer groups selected under this new process.

### ***Realizable Pay***

Many supplemental proxy filings in 2012 that were issued in response to “against” recommendations by ISS asserted that ISS had materially overstated CEO pay by allocating the full grant date value of long-term incentive awards to the year of grant and by not taking into consideration the likely value (if any) that the individual would receive from the awards.

ISS made a brief, general statement in its 2013 policy update that for “large cap” companies it will add consideration of realizable pay to its research reports. At this point, the only details provided by ISS are that:

- realizable pay for a particular performance period will consist of the value of cash and equity-based awards “made” during the performance period being measured, based on (a) for actual earned awards, the actual equity award value using the stock price at the end of the period (or cash value, presumably); and (b) for ongoing awards, the target value, calculated using the stock price at the end of the performance measurement period; and
- stock options and stock appreciation rights will be subject to revaluation using the remaining term and updated assumptions.

We will continue to monitor how realizable pay is being evaluated as ISS begins issuing reports under its new policies, and provide updates in that regard as part of our periodic client mailings throughout the 2013 proxy season.

### ***Say on Golden Parachutes Vote***

While the non-binding vote to approve named executive officer compensation in the context of a transaction (the so-called “Say on Golden Parachutes” vote) has received less attention than the annual “Say on Pay” vote, ISS pointed out in its 2013 policy report that while Say on Pay proposals have achieved an average approval rate of 91%, Say on Golden Parachutes proposals have achieved

an average approval rate of only 81% (and this in the context of the underlying transactions having received an average approval rate of 95%).

In response, in a significant ISS policy change, ISS will include all existing provisions of a company's compensation arrangements in its review. This is contrary to its past policy of ignoring any existing ("grandfathered") provisions (such as previously negotiated "golden parachute" excise tax gross-ups). While recently adopted provisions will carry more negative weight in this analysis, existing provisions also will be considered, and the presence of multiple existing problematic provisions will be scrutinized with extra care.

The list of problematic provisions cited by ISS includes:

- single- or modified-single-trigger cash severance;
- single-trigger acceleration of unvested equity awards;
- "excessive" cash severance (more than three times base salary and bonus);
- excise tax gross-ups that are actually triggered and payable;
- "excessive" golden parachute payments (on an absolute basis or as a percentage of transaction value); and
- recent actions (such as unusually large equity grants) that may have inappropriately motivated executives to enter into a transaction that may not be in the best interests of shareholders.

While ISS did not indicate that it will scrutinize existing arrangements in the context of the annual Say on Pay vote, the elimination of grandfathering in the Say on Golden Parachute vote will place fresh scrutiny on arrangements that many companies had considered to be off-limits from ISS review.