

November 19, 2012

ISS Moderates Proposed Voting Policy Updates for the 2013 Proxy Season

Institutional Shareholder Services has released its [2013 Corporate Governance Policy Updates](#), which represent a more moderate approach than the [proposals it released for comment](#) in October. These changes, which will generally apply for the 2013 proxy season, continue the trend of narrowing director discretion in matters traditionally considered to be within directors' authority. In addition, ISS' expansion into social policy matters appears often to be at odds with shareholder and corporate interests and is far more likely to benefit special interest groups. It should be noted, though, that ISS took into account many of the comments it received and in some cases moved from a one-size-fits-all approach to a more appropriate case-by-case analysis. Although it is important that boards of directors be cognizant of ISS voting policies, it is essential that, in their decision-making, directors carefully consider the best interests of the corporations they serve and not merely defer to shareholder advocacy groups

Board Responsiveness to Majority Supported Shareholder Proposals. Although ISS will tighten its policy and recommend that shareholders vote "against" or "withhold" their votes for incumbent directors who fail to act on a shareholder proposal that received the support of a majority of votes *cast* in the previous year, it has – [as we](#) and others urged – implemented a transition rule, so that the tighter standard will only commence with shareholder proposals appearing in companies' proxy statements in 2013, and will not apply retroactively. For shareholder proposals that won a majority of votes cast during the 2012 proxy season, board responsiveness will be assessed under the existing standard, which requires approval by a majority of *outstanding* shares the previous year or the support of a majority of votes cast in both the last year and one of the two prior years. While we continue to believe that the change to the current policy may impede board effectiveness by discouraging boards from considering long-term strategy when evaluating shareholder proposals, ISS has appropriately determined not to impose the harsher standard retroactively.

ISS has stated that it considers a board to have responded to a shareholder proposal if the board either fully implements the proposal or, if a shareholder vote is required, includes it as a management proposal on the next annual ballot. ISS will consider responses involving less than full implementation on a case-by-case basis, taking into account several factors, including the subject matter of the proposal and level of shareholder support shown, outreach efforts by the board to shareholders in the wake of the vote and actions taken by the board in response to its engagement with shareholders.

Voting on Director Nominees in Uncontested Elections. ISS currently recommends that shareholders vote "against" or "withhold" their votes for incumbent directors, even in uncontested elections, when the company has experienced certain extraordinary circumstances including, among others, material failures of governance stewardship, risk oversight, or fiduciary responsibilities at the company. ISS has specified that, starting next year, failures of risk oversight will include bribery, large or serial fines or sanctions from regulatory bodies, significant adverse legal judgments or settlements, hedging of company stock or "significant" pledging of company stock. This policy update is a shift from ISS' [original proposal](#), which sought to categorize *any* pledging of company stock as a problematic pay practice that could lead to a negative say-on-pay recommendation, rather than a failure of risk oversight. In our view, categorizing only

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“significant” pledging of company stock as a failure of risk oversight provides for a more nuanced case-by-case consideration of pledging practices, rather than a one-size-fits-all approach.

Realizable Pay. For large capitalization companies only, ISS will not only look to the value of compensation granted to executives generally as reported in the summary compensation table, but will add the concept of “realizable pay” to its analysis. 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 awards actually earned and target values for ongoing awards, calculated using the stock price at the end of the performance measurement period. Stock options or stock appreciation rights will be re-valued based upon the remaining term and updated assumptions, using the Black-Scholes option pricing model.

Golden Parachute “Say-on-Pay” Vote. ISS has modified its analysis of the golden parachute “say-on-pay” vote to include consideration of existing change of control arrangements and not merely newly-adopted agreements, as was the case under the current policy. While recent amendments that incorporate so-called problematic features (*e.g.*, golden parachute excise tax gross-ups and single trigger payments) will carry more weight in the overall analysis, it appears that the presence of multiple legacy “problematic” features will also be closely scrutinized.

Pay for Performance Peer Group Selection Methodology. In performing its pay for performance analysis, ISS previously focused on the subject company’s GICS industry peers, which frequently omitted competitors of the target company and/or included firms that were not competitors of the subject company for business or talent. ISS’ new methodology draws peers from the subject company’s GICS group as well as from GICS groups represented in the subject company’s self-selected peer group. The methodology additionally focuses initially at an 8-digit GICS code (a broad group) to identify peers that are more closely related in terms of industry. Finally, when selecting peers, the methodology prioritizes peers that maintain the company near the median of the peer group, are in the subject company’s peer group, and have chosen the subject company as a peer. In addition, ISS has slightly relaxed its size requirements, especially at very small and very large companies, and will use revenue instead of assets for certain financial companies.

Director Attendance; Overboarded Directors. Starting next year, ISS will recommend that shareholders vote “against” or “withhold” their votes for: (1) individual directors who attend less than 75% of their board and committee meetings for the period for which they served, unless an acceptable reason is disclosed in an SEC filing; and (2) individual directors for whom proxy disclosure is insufficient to determine whether such directors met the 75% attendance threshold.

In addition, ISS will no longer count publicly-traded subsidiaries owned 20% or more by the parent as one board with the parent company when determining the number of boards on which a director sits, and will continue to consider serving on more than six public company boards to be excessive. All subsidiaries with publicly-traded stock will be counted as boards in their own right, except such subsidiaries that only issue public debt. Mutual funds will continue to be rolled up to the mutual fund families, with one family counting as one board. Directors who sit on the boards of publicly-traded subsidiaries should re-evaluate their commitments to avoid inadvertently facing a negative recommendation from ISS.

Other Changes. As ISS previously [proposed](#), it has changed its recommendation for shareholder proposals to link executive compensation to environmental and social criteria from an automatic recommendation “against” to a “case-by-case” analysis. In adopting the change, ISS noted that incorporating sustainability-related non-financial performance metrics into executive compensation is becoming increasingly common in certain sectors, including the extractive industry sectors. ISS has also revised its policy position on proposals requesting information on a company’s lobbying activities to clarify that “lobbying activities” includes direct, indirect and grassroots lobbying, and not just direct lobbying. ISS’ expansion further into areas of social policy, however laudable it may appear to be, is in our view inappropriate and more likely to benefit special interest groups than businesses and the investors ISS purports to represent.

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ISS’ 2013 policy updates generally continue the incremental shift towards a shareholder-centric model of corporate governance that may be at odds with the best interests of the companies that boards serve. As companies begin to prepare for the 2013 proxy season, they must be mindful of anticipated or actual negative recommendations and consider whether to proactively engage with shareholders to counteract any such recommendations. However, we continue to believe that in evaluating and responding to shareholder proposals, as in every decision they make, directors must carefully consider the best interests of the corporations they serve and not merely defer to shareholder advocacy groups.

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