

October 30, 2012

ISS Proposes Changes to 2013 Voting Policies

The recent announcement by Institutional Shareholder Services (ISS) of [proposed changes to its voting policies](#) for the 2013 proxy season represent a further shift towards the shareholder-centric model of corporate governance that ISS, certain academics and powerful institutional shareholders and groups have long been advocating. The proposed changes would seek to further limit the flexibility of boards of directors and address board responses to majority-supported shareholder proposals, management say-on-pay proposals, say on golden parachute proposals and proposals to link executive compensation to environmental and social criteria. Comments on the ISS proposals are due October 31, 2012, although this deadline may be extended.

Board Response to Majority-Supported Shareholder Proposals. Starting next year, ISS proposes to sanction directors who do not immediately accede to majority-supported shareholder proposals. Under the proposed policies, ISS would 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, even if the support does not represent a majority of outstanding shares. (ISS currently recommends against directors for failing to act on a shareholder proposal only if the proposal received the support of a majority of the outstanding shares or a majority of the votes cast in both the last year and one of the two prior years.) As is already evident from the dismantling of takeover defenses in many American public companies, the threat of negative ISS recommendations has a coercive impact on corporate policies and governance that far exceeds ISS’ qualifications or authority to dictate. Corporate directors should carefully consider the best interests of the corporations they serve, not merely defer to shareholder advocacy groups. ISS’ latest push for immediate board obedience could deny directors the ability to fully consider long-term strategy when evaluating shareholder proposals, and empower special interest groups and others with short-term interests.

ISS has stated that if the proposed policy is applied to the 2013 proxy season, it may recommend “against” or “withhold” votes for incumbent directors at 24 companies, if those companies do not “sufficiently implement” shareholder proposals that won a majority of votes cast during the 2012 proxy season (but not a majority of shares outstanding). We believe it would be grossly unfair for ISS to impose its policy retroactively, by recommending “against” or “withhold” votes in 2013 for incumbent directors who do not “sufficiently implement” shareholder proposals that last year received only a majority of votes cast.

Management Say-on-Pay Proposals. In connection with management say-on-pay proposals, ISS has proposed two changes to the current methodology used for the pay for performance evaluation and one addition to the current list of problematic pay practices. In recognition of the fact that the GICS peer group does not in all cases include a company’s competitors or includes companies with no clear connection to the subject company, for purposes of determining the peer companies used for the peer group alignment portion of the pay for performance evaluation, ISS is proposing to include peer companies in the subject company’s self-selected GICS industry group, in addition to the GICS industry group, with a continued focus on size and market capitalization. As part of the qualitative evaluation of pay-for-performance alignment for large cap companies, ISS is also considering including a factor that takes into account a comparison of realizable pay to grant date pay. For this purpose, “realizable pay” is proposed to be “the sum of relevant cash and equity-based grants and awards made during a specified

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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 notes that this policy change may mitigate or exacerbate pay for performance concerns. While this change may be informative for purposes of the ISS pay for performance evaluation, if implemented, companies may feel compelled to include disclosure of realizable pay based on the articulated ISS standards, and we question the usefulness and reliability of additional disclosure that is not required by the current SEC disclosure rules.

In addition, ISS has proposed to categorize pledging of company stock by company directors or officers as a problematic pay practice, which could result in a negative say-on-pay recommendation. In support for this proposed change, ISS cited concerns that directors could pledge company stock as part of a hedging strategy that would insulate directors against economic exposure to the company’s stock or that a forced sale by an officer in response to a margin call could negatively impact the company’s stock price and potentially violate company insider trading policies. While ISS recognizes that “pledging policies are not tied to compensation,” it indicates that “the say-on-pay proposal appears to be a reasonable action for shareholders to initially communicate objections to such policies” since “a substantial portion of shares owned by most executives and outside directors are delivered under compensation programs.” We believe that there are better ways to communicate objections to pledging policies and that the current “case-by-case” analysis undertaken by ISS is sufficient to address any concern.

[Say on Golden Parachute Proposals](#). The draft policies would update the current ISS policy on say on golden parachute proposals by including existing change-in-control arrangements with named executive officers in the analysis, rather than focusing only on new or extended arrangements, and placing further scrutiny on features in existing change-in-control agreements viewed by ISS as problematic. The ISS proposal notes that in the short voting history of say on golden parachute proposals, the average support for such proposals across ISS’ coverage universe was approximately 81 percent and that the proposed changes are in response to investor concerns about excessive golden parachute payments based on an ISS policy survey, in particular noting that a majority of investor respondents do not favor single trigger equity vesting upon a change in control. The relevance of say on golden parachute proposals continues to remain unclear and, in our experience, while say on golden parachute proposals frequently receive a lower favorable vote than the vote on the actual transaction, they continue to receive a majority vote even if there is a negative ISS vote recommendation.

ISS’ proposed policies reflect a narrow, issues-based approach to corporate governance that could result in the loss of long-term shareholder value. In addition to the policies described above, ISS has [proposed changing its policy](#) for shareholder proposals to link executive compensation to environmental and social criteria from an automatic recommendation “against” to “case-by-case,” creating uncertainty as to how these proposals will be treated. As always, it is critical that boards be aware of ISS’ methodologies and take steps to address anticipated or actual negative recommendations. Particularly if ISS’ proposed changes are applied retroactively, companies in potentially vulnerable positions should consider engaging with their shareholders prior to the 2013 proxy season to explain their unique business and governance situation.

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