ISS Releases 2013 Global Policy Updates

On November 16, Institutional Shareholder Services (ISS) released its policy updates to its voting guidelines for the 2013 proxy season. The updates were largely consistent with the proposed guidelines published in October. Key policy changes in 2013 for the United States include ISS's position on recommending against directors of companies whose executives have engaged in hedging or pledging of company stock and companies that have failed to respond to majority-supported shareholder proposals, the selection of the ISS peer group for purposes of a company's quantitative say-on-pay analysis, the use of "realizable" pay as part of a company's qualitative say-on-pay analysis and ISS's standards for evaluating golden parachute proposals.

In general, the policy updates are effective for shareholder meetings held on or after February 1, 2013. ISS has indicated that it will release revised Frequently Asked Questions (FAQs) that will provide additional guidance related to some of the revised policies in December 2012. ISS will also be hosting a global webinar on December 6 that will cover the updated policies and a preview of key issues facing investors and issuers in the coming year.

Voting on Director Nominees

Hedging and Pledging of Company Stock. Under existing voting guidelines, ISS may recommend voting against or withholding from directors as a result of material failures of risk oversight. In its 2013 update, ISS has identified hedging or significant pledging of company stock by executives and directors as an example of a material failure of risk oversight. Notably, under the updated policy, any amount of hedging will be considered a problematic practice warranting an automatic negative vote recommendation. The pledging of company stock by executives and directors, in contrast, will not automatically result in a negative vote recommendation, but will be evaluated on a case-by-case basis. In making that evaluation, ISS will consider a number of relevant factors, including the magnitude of pledged shares relative to total outstanding shares, market value or trading volume, the disclosure of an anti-pledging policy for future transactions and disclosure indicating that shares subject to stock ownership and holding requirements do not include pledged company stock. ISS will also consider whether the company has disclosed any progress (or lack thereof) in reducing the magnitude of aggregate pledged shares over time.

Board Response to Majority-Supported Shareholder Proposals. ISS currently recommends voting against or withholding from the entire board of directors (except new nominees, who are considered on a case-by-case basis) if the board failed to act on a majority-supported shareholder proposal. For the 2013 proxy season, ISS has updated its policy to include the ability to recommend against individual directors or committee members, if appropriate, and includes additional guidance on factors that will be taken into account when examining the sufficiency of a company's action in response to a majority-supported shareholder proposal. In 2014, ISS will begin to use a majority of shares cast in the prior year as the trigger to evaluate a company's response to majority-supported shareholder proposals. For 2013, the triggers will continue to be a majority of shares outstanding in the prior year or a majority of shares cast in the prior year and one of two prior years. Additional guidance on this change is expected to come in December 2012 in the revised FAQs.

Executive Pay Evaluation

Peer Group Selection. In response to criticism of its existing methodology for selecting a company's peer group for purposes of its quantitative evaluation of company pay-for-performance, ISS has modified the peer group selection process to include peers drawn from a company's self-selected peer group. In considering which company-selected peers to include in its own peer group, ISS will focus on relative size in terms of revenue/assets, market capitalization and industry and will prioritize those peers that have chosen the subject company as a peer as well. ISS estimates that under the new methodology 80 percent of the ISS-selected peer group will consist of companies from the company's 8-digit GICS group or from its self-selected peers. Under the current methodology only 40 percent of the ISS peers were from a company's 8-digit GICS group.

Realizable Pay. Companies that ISS determines have an unsatisfactory alignment between pay and performance under the quantitative test are subject to an additional qualitative test. For large capitalization companies, the 2013 guidelines add a comparison of realizable pay to grant date pay to this qualitative analysis, in response to favorable issuer and investor reaction to increased disclosure of measures of pay that can be realized based on actual performance, rather than grant date value. For a specified performance period, realizable pay will consist of the sum of relevant cash and equity-based grants and awards made during that period, 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 period. Stock options and stock appreciation rights will be re-valued using the remaining term and updated assumptions using a Black-Scholes option pricing model. The ISS update notes that realizable pay may mitigate or exacerbate pay-for-performance concerns.

Golden Parachutes. ISS has revised its policy on say-on-golden parachute advisory votes to include a review of existing change-in-control arrangements maintained with named executive officers rather than focusing only on new or extended arrangements. Features that may result in a recommendation against a say-on-golden parachute vote include: single- or modified-single-trigger cash severance; single-trigger acceleration of unvested equity awards; cash severance in excess of three times base salary and bonus; golden parachute payments that are excessive on an absolute basis or as a percentage of transaction equity value; and triggered and payable excise tax gross-ups. Recent amendments incorporating such problematic features 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 may also garner a negative recommendation on a company's golden parachute advisory vote, as may a company's assertion that a proposed transaction is conditioned on shareholder approval of the vote. While the revised policy guideline states that recent amendments incorporating problematic features will carry more weight in the overall analysis, ISS will also closely scrutinize multiple legacy problematic features.

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