ISS Previews 2013 Policy Updates

Institutional Shareholder Services, Inc., the prominent corporate governance advisory services firm, has published a preview of some of its likely updates to its corporate governance policies for U.S. companies for the 2013 proxy season. Although it is not a comprehensive summary of all of the policy changes that may apply in 2013, the preview highlights two important items for technology and life sciences companies, including its methodology for evaluating the shareholder advisory vote proposals on executive compensation ("Say-on-Pay") required under the Dodd-Frank Wall Street Reform and Consumer Protection Act and how ISS will evaluate the shareholder advisory votes on "golden parachute" compensation that are held in connection with business combinations and other corporate transactions.

ISS is inviting companies, shareholders, and other market participants to comment on the proposed policy updates before it finalizes the policies for next year. Time to respond is limited, however, as comments must be received by October 31, 2012. ISS plans to issue its final 2013 U.S. and International Policy updates on or around November 15 and its Global Policy Summary and Concise Guidelines in December.

ISS' updated policies will be effective for shareholder meetings held after February 1, 2013.

Background

As a long-time advisor to the institutional investor community, ISS has established itself as a bellwether for the key shareholder issues to be addressed each proxy season. ISS regularly publishes annual updates to its standards on good corporate governance and executive compensation policies and practices. These standards, which are contained in a series of policy statements, including a comprehensive "Executive Compensation Evaluation" policy statement, are used by ISS to formulate the voting recommendations that it provides to its clients for the election of directors and other proposals submitted for shareholder action at annual shareholders' meetings, as well as to analyze companies' corporate governance and executive compensation policies and practices.

On October 16, 2012, as a prelude to the publication of its policy guidelines for 2013, ISS announced that it was soliciting comments from companies, shareholders, and other market participants on a number of the policy updates under consideration. While the proposed updates to do not reflect all of the policies that will apply during the 2013 proxy season, they represent the more significant issues that arose during the 2012 proxy season.

Here are the key proposals affecting executive compensation matters for U.S. companies.

Three Things Technology and Life Sciences Companies Should Know About the Pending ISS Policy Updates

- ·Evaluating Say-on-Pay Proposals – In response to significant criticism of the pay-for-performance methodology that it introduced in 2012, ISS is proposing to (a) include the industries reflected in a company's own compensation peer group as an input in analyzing the degree of alignment between a CEO's total compensation ranking and the company's total shareholder return ranking and (b) add a comparison of the CEO's "realizable" pay to his or her "granted" pay to its qualitative evaluation of factors that may work to encourage or undermine long-term value creation and alignment with shareholder interests.
- Pledging of Company Stock – Responding to long-standing shareholder concerns, ISS is proposing to add the absence of a policy restricting or prohibiting the pledging of company stock to its list of problematic pay practices that may lead to an "against" vote recommendation.
- Say-on-Golden Parachute Votes – ISS is proposing to revise its policy for evaluating a Say-on-Golden-Parachute vote proposal, including a review of legacy change-in-control arrangements.

ISS Previews 2013 Policy Updates (continued)

Evaluating a Say-on-Pay Proposal

Unequivocally, ISS' methodology for analyzing an executive compensation program in the context of a Say-on-Pay proposal was the most controversial topic during the 2012 proxy season. Employing a revised approach to evaluate a company's pay-for-performance alignment, ISS came under severe criticism from many quarters for several aspects of this approach. First, it was criticized for its peer group selection process, which largely ignored the company's own compensation peer group. It was also criticized for relying on the total compensation figure reported in the Summary Compensation Table – with its inflated stock option values – as the indicator of a chief executive officer's annual pay. Finally, it was unclear how ISS conducted its qualitative assessment of a company's executive compensation program after it identified a pay-for-performance misalignment. While ISS disclosed some of the factors that went into this assessment, it wasn't clear how these factors were weighted or their impact on its overall analysis.

ISS is proposing to revise its methodology as follows:

- Expand the scope of possible companies to be included in its self-constructed peer group to include companies in the industries reflected by the GICS codes of the companies in the company-constructed compensation peer group, subject to pre-determined company size and market capitalization constraints.
- Incorporate a comparison of a CEO's realizable pay to grant date pay as part of the qualitative evaluation of a company's executive compensation program.
- Add the pledging of shares as a factor that may lead to an "against" vote recommendation under its existing "problematic" pay practices evaluation.

Observations. Although the ISS proposals purport to address the key criticism of its pay-for-performance analysis in 2012 – the selection of the peer group against which CEO pay is compared, it is not clear how this new input (that is, the company-constructed compensation peer group) will ultimately impact the ISS peer group determination. It appears that, to the extent that one or more of the companies in the company's compensation peer group are outside the company's own GICS classification, that fact will have some effect by possibly expanding the range of potential peers. However, as before, it appears that size (revenue and market capitalization) considerations will play a deciding factor in the selection process. While this, by itself, is not objectionable, it remains unclear whether other considerations (such as competitive status and location) – which often influence the composition of a company-constructed peer group – will carry any weight in the process. Consequently, companies will go into the 2013 proxy season still unsure of which companies they will be compared against for purposes of the pay-for-performance analysis, which has turned out to be the most critical aspect of the ISS review.

As for the inclusion of realizable pay in the qualitative component of the analysis, it is only one of several factors that go into the assessment. Once again, from the proposal it is not clear how much weight this factor will carry in the evaluation. Further, realizable pay is being compared to "granted" pay (presumably meaning the compensation reported in the Summary Compensation Table) rather than to the company's performance. To date, this is not how this data has been used, so it remains to be seen what impact it will have on the ISS analysis. At this point, if the proposal is adopted in its current form, this enhancement is likely to significantly increase the number of presentations comparing performance to realizable pay where a company has a good story to tell.

Say-on-Golden-Parachute Votes

In addition to the more well-known Say-on-Pay vote and its related shareholder advisory vote on the frequency of future Say-on-Pay votes, the Dodd-Frank Act also introduced a third shareholder advisory vote involving the approval of any compensation payable to named executive officers in connection with a merger, acquisition, or other corporate transaction. Because the requirement to conduct Say-on-Golden-Parachute votes did not become effective until the 2011 proxy season was well under way, it took ISS well into 2012 to gather data on the outcome of these votes and gauge current investor sentiment on "golden parachute" arrangements.

As a result, ISS is proposing several significant changes to its current policy on Say-on-Golden Parachute proposals to include a review of existing change-in-control arrangements maintained with a company's named executive officers – rather than focusing primarily on new or extended arrangements, and to place further scrutiny on multiple legacy problematic features in change-in-control agreements.

Thus, as has been the case for several years when identifying so-called “problematic” pay practices, under the revised policy, ISS may recommend “against” a Say-on-Golden-Parachute proposal where a company’s change-in-control arrangements include one or more of the following features:

- Single- or modified-single-trigger cash severance;
- Single-trigger acceleration of unvested equity awards;
- Excessive cash severance (that is, severance payments in excess of three times base salary and bonus);
- Excise tax gross-ups triggered and payable (as opposed to a provision to provide excise tax gross-ups);
- Excessive golden parachute payments (on an absolute basis or as a percentage of transaction equity value); or
- Recent amendments that incorporate any problematic features (such as those above) or recent actions (such as extraordinary equity awards) that may make packages so attractive as to influence merger agreements that may not be in the best interests of shareholders.

Similarly, ISS may recommend “against” a Say-on-Golden-Parachute proposal where a company asserts that a proposed transaction is conditioned on shareholder approval of the Say-on-Golden-Parachute proposal.

ISS indicates that, in evaluating the features of a company’s change-in-control arrangements, it will take into account the number and magnitude of the "problematic" features, and, in some instances, the timing of the issue or issues.

Where approval of the change-in-control arrangements has been incorporated into a company’s Say-on-Pay vote (which is permitted by the Dodd-Frank Act to enable companies to potentially sidestep the separate vote at the time of the transaction), ISS will evaluate the Say-on-Pay proposal using the same guidelines, which may give greater weight to that component of the overall evaluation of the company’s executive compensation program.

Observations. Even though ISS is contemplating increasing its scrutiny of change-in-control arrangements generally, as well as in the context of a Say-on-Golden-Parachute vote, it is unlikely that this change will have a dramatic effect on corporate transactions and current design and disclosure practices. Of the approximately 100 companies that have conducted Say-on-Golden-Parachute votes and reported the results of these votes, only three have failed to receive at least majority support (70% of the companies received 80% or greater support of their Say-on-Golden-Parachute proposal) and not one of the votes has had an adverse impact on the approval of the related transaction. Thus, even though (as ISS has cited) the Say-on-Golden-Parachute vote has received, on average, 10%-15% less support than the related transaction, it is unclear that companies have placed much weight on the impact of the vote.

In addition, few companies (and, almost without exception, no large companies) have taken advantage of the exception to the Say-on-Golden-Parachute vote requirement for Say-on-Pay votes that include enhanced disclosure of the change-in-control arrangements. One of the principal reasons for this development is concern over the heightened scrutiny that ISS gives to change-in-control arrangements in the context of the Say-on-Pay vote.

Finally, the "problematic" features that ISS cites as influencing its vote recommendation have been well publicized in recent years as objectionable. As a result, most companies have removed such features from their change-in-control arrangements where possible and have refrained from including them in new arrangements. Thus, even though ISS believes that the impact of the proposed policy changes will likely increase the number of negative vote recommendations, this assumes a level of legacy arrangements that, in fact, continues to shrink with each passing year. In practice, it’s likely that many, if not most, vote recommendations will turn on qualitative considerations (such as whether the overall content of the package had an undue influence on the related transaction) rather than quantitative considerations.

Other Policy Updates

Board Response to Majority-Supported Shareholder Proposals

For many years, institutional investors have expressed frustration when a company has failed to implement – or even respond to – a shareholder proposal that has received sustained support. This discontent has now crystalized into some fairly rigid expectations. According to ISS, 86% of the institutional investor respondents to its 2012-12013 Policy Survey (as well as 47% of the issuer respondents) indicated that a board of directors should implement a shareholder proposal that, in the prior year, received support from a majority of the votes cast on the proposal.

ISS is proposing to enhance its current policy to hold directors accountable for a failure to respond to a shareholder proposal that receives, in a single year, a majority of the votes cast. As proposed, ISS will recommend a vote "against" or a "withhold vote" from the entire board of directors (except new nominees, who will be considered on a case-by-case basis) if the board fails to act on a shareholder proposal that received the support of a majority of the votes cast in the previous year.

Observations. Although this policy position appears draconian, it should be noted that board action on a majority-supported shareholder proposal does not necessarily equate with implementation. While in many instances this will be the result (especially in the case of proposals that have received an ever-increasing level of support over several years), the proposed policy update seeks board responsiveness, which may mean simply engaging with shareholders on the matter reflected in the proposal in order to reach a mutually-satisfactory outcome. In light of the increased shareholder engagement that has resulted from the introduction of Say-on-Pay, it is unlikely that a proposal that generates majority support would involve an issue of which the company was previously unaware and that has not already been the subject of a robust discussion among the affected stakeholders. Thus, the company should be in a position to offer a considered response in the event that it decides that the proposal is not in its best interests.

Environmental and Social Non-Financial Performance Compensation-Related Proposals

According to ISS, approximately two-thirds of the investor respondents to its 2012-2013 Policy Survey expressed an interest in seeing companies use environmentally- or socially-oriented (and distinctly non-financial) performance measures in their executive compensation programs.

In response to this development, ISS is considering changes to its existing policy on shareholder proposals addressing environmental or social non-financial performance measures. Instead of recommending a vote "against" such proposals, it would shift to an approach where, on a case-by-case basis, it would take the following factors into consideration in evaluating proposals intended to link executive compensation to sustainability (environmental or social) criteria:

- Whether the company has significant and/or persistent controversies or violations regarding social and/or environmental issues;
- Whether the company has management systems and oversight mechanisms in place regarding its social and environmental performance;
- The degree to which industry peers have incorporated similar non-financial performance criteria in their executive compensation practices; and
- The company's current level of disclosure regarding its environmental and social performance.

Observations. An evolving issue that is currently most relevant in select industry sectors (such as the extractive industry sector), this is probably not yet a top-of-mind concern for technology and life sciences companies. Nonetheless, if the recently-adopted disclosure rules on conflict minerals are any indication, it's an area that warrants monitoring.

What's Next

ISS is soliciting comments on the proposed policy updates until October 31, 2012. ISS has indicated that it plans to issue its policy updates for 2013 on or about November 15, 2012. As in prior years, the policy updates will go into effect at the beginning of February of the following year; in this case, February 1, 2013.

To access the ISS portal to its proposed policy updates, click here »

Need Assistance?

Compensia has significant experience in helping companies understand and address ISS' corporate governance and executive compensation policies. If you have any questions on the topics covered in this Thoughtful Pay Alert or would like assistance is assessing how the policies are likely to affect your executive compensation program, please feel free to contact us. ■

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