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EXEQUITY

Independent Board and Management Advisors

Client Alert

ISS Issues Draft 2013 Policies

On October 16, 2012, ISS issued ***draft*** 2013 Policies for comment.[1] Comments can be submitted through ***October 31, 2012***.[2] This is a very short comment period, but ISS already solicited comments through its 2012–2013 Policy Survey this summer. The draft policies appear to make an attempt to address some of the concerns raised by corporate issuers in the last proxy season, especially in the construction of peer groups. Although ISS posed a number of questions for comment, we would not be surprised if ISS adopts as final what is substantially proposed. Note also that these draft policies do not necessarily include all of the policies ISS may be issuing in November as part of its final 2013 Policy changes, only the ones for which ISS is seeking further comment.

In summary, the draft U.S. policies address four issues, specifically:

- Management Say-On-Pay (MSOP) Proposals, specifically ISS's peer group methodology, adding realizable pay as a consideration as part of its qualitative analysis, and including the pledging of company stock as a "major" problematic pay practice.
- Board Response to Majority-Supported Shareholder Proposals.
- Say on Golden Parachute (SOGP) Proposals.
- Environmental and Social Non-Financial Performance Compensation Related Shareholder Proposals.

Additional information on the draft policies follows.

MSOP Proposal Policy Changes

ISS is proposing several changes to its MSOP Policy:

- Using the company's selected peers as an input to ISS's peer group methodology, while maintaining the policy's existing company size and market capitalization constraints.
- Potentially incorporating a comparison of realizable pay to grant date pay as part of the qualitative analysis of pay-for-performance (P4P) alignment.
- Adding pledging of company shares as a practice that may lead to negative vote recommendations under ISS's existing problematic pay practices policy.

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[1] These draft policies are available at: http://www.issgovernance.com/policycomment2013.
[2] Comments can be submitted by emailing them to: policy@issgovernance.com.

Peer Group Methodology

ISS is proposing that in developing the peer group it uses as part of its relative analysis of a company's P4P alignment, it will now reference a company's selected peers' GICS industry groups with size constraints. ISS indicates that the revenue, total assets (for banks and financial services companies), and market value size criteria may be relaxed at very large and very small companies, and revenue might be used instead of assets at some financial companies.

ISS will focus initially on the 8-digit GICS group of the company and its peers to identify companies that are more closely related to the subject company in terms of industry. When selecting peers, ISS's new methodology prioritizes peers that maintain the subject company near the median of the peer group, are in the subject company's peer group, and that have chosen the subject company as a peer.

The intent is to create a peer group consisting of between 14 and 24 companies, as is currently specified in the policy. Under the current methodology, a number of exceptions were created for very large companies as well as for some companies for which ISS found it difficult to create a robust peer group. The details provided in the draft policy do not indicate any exceptions, but perhaps the final policy updates will include those.

Significantly, ISS indicates that it will no longer use the 2-digit GICS code to develop peer groups.

Realizable Pay for Qualitative Analysis

ISS is suggesting adding an additional qualitative factor it will consider as part of its qualitative analysis, realizable pay compared to grant pay. ISS did not fully set forth its methodology to calculate realizable pay. However, ISS indicated that 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 actual earned awards, or target values for ongoing awards, calculated using the stock price at the end of the performance period. ISS also indicates that **realizable pay can** be used to **both mitigate** and **exacerbate CEO P4P concerns**.

Pledging of Company Stock: A Problematic Pay Practice

ISS is proposing to add pledging of company stock as a problematic practice that carries significant weight in its consideration of non-performance-based compensation elements that alone could cause ISS to issue a negative vote recommendation under its MSOP Policy.

Request for Further Comment

ISS is seeking comment on the following aspects of its draft MSOP Policy updates:

Peer Group Methodology

- Are there additional or alternative ways that ISS should use the company's self-selected peer group to inform its peer group construction?
- Since company size is highly correlated with levels of executive pay, what is a reasonable size range (revenue/assets) for peer group construction?
- Are there additional factors that investors should consider in peer group construction for P4P evaluation?

Realizable Pay

- How would you define realizable pay?
- Should stock options be considered based on intrinsic value or Black-Scholes value, and what is the rationale for your choice?
- What should be an appropriate measurement period for realizable pay? One year, or three years, or five years or others?

Pledging of Company Stock

- What would you consider a “significant” level of pledging of company stock that causes concern for investors?
- If pledging raises concerns significant enough to warrant voting action, should this action be directed at the (i) MSOP proposal (if available), (ii) the board, or (iii) members of one of the board committees (e.g., audit, governance, compensation—please specify)?
- Would you consider a company’s remedial actions on pledging (such as a commitment not to pledge in the future, commitment to unwind their positions within a reasonable period) to be sufficient to address concerns?
- Are there additional factors that investors should consider for the case-by-case analysis?

Exequity Comment: *ISS has not fully divulged the process it will use in creating peer groups that consider a company’s self-selected peers. A number of technical issues regarding how ISS will apply the process and how it will balance the stated competing interests in creating its peer group for purposes of its P4P analysis still exist. The accompanying detail shows that ISS took to heart the criticism it heard during the 2012 proxy season concerning its peer group methodology and is trying to address it in a way that will result in a greater overlap with a company’s own self-selected peers (42% of companies would have an overlap with their self-selected group under the 2013 methodology versus only 20% of companies with an overlap under the current 2012 methodology). ISS also claims that its new methodology will do a better job at placing the subject company at +/- 20% of the peer group’s median revenue size (90% of companies under the 2013 methodology versus 82% under the current 2012 methodology). But, as we know, the devil is in the details. So until ISS provides additional guidance on how it will apply this proposed revised policy, we will not know the full ramifications for companies. At the very least, it looks like this will add some additional complexity into the ISS peer group methodology as well as some additional subjectivity given the competing goals ISS expressed in creating its peer groups. We expect this will make it more challenging for companies to try and anticipate the exact peer group that ISS will use for its P4P analysis.*

As for the addition of realizable pay as an additional qualitative factor for ISS to consider as part of its P4P analysis, we think ISS is acknowledging a growing company practice of providing shareholders with alternative views on their compensation and the importance ISS’s subscribers have placed on such disclosures. Again, without specific technical guidance on ***how*** *ISS will calculate realizable pay, it is difficult to anticipate the full impact of this change. Given the questions ISS is seeking comment on, it remains to be seen whether ISS will use intrinsic or Black-Scholes values for outstanding stock options and stock appreciation rights at the end of the performance period. ISS is also seeking comments on what performance period should be used. We note that the current methodology uses a 1-year and*

3-year period for purposes of its relative P4P analyses and a 5-year period for its absolute P4P test. Another question that remains unanswered is whether they will look at realizable pay on an absolute or a relative (or both) basis. Presumably, they will align the performance period to the same periods they use under the existing P4P analysis. At any rate, it will likely be difficult for companies to try and figure out how ISS might come out on their qualitative assessment.

*As for the pledging of company stock potentially being made a problematic pay practice, we are not surprised. Many "best practice" lists indicate that allowing company stock hedging and pledging by executives and/or directors is not considered a best practice. ISS cites a CFRA (an MSCI brand) study (*Review of Pledged Insider Pledged Share Disclosure, May 17, 2012) *which found that approximately 15% of Russell 3000 companies had one or more executives or directors that had pledged shares for margin accounts or other loans. The study found that the average value of shares pledged at such companies was $57.4 million and represented approximately 2% of the company's market value (but note that the median value was only $5.07 million, representing 0% of the company's market value). ISS is seeking comment on whether allowing any type of commitment to address pledging of shares would be sufficient to address investor concerns. Given that this is not a prevalent market practice and that even among those companies that have had executives and/or directors pledge shares it does not appear to represent a significant amount of the company's market value at median, we hope that if ISS makes pledging a problematic pay practice that it permits companies to make commitments to address pledging as it did in the past when it first introduced its problematic pay practices. If ISS adopts this approach to permit commitments, we expect it will be a stop-gap measure that will be kept in place for a few years, giving companies time to clean up their pledging issues before ISS would no longer accept commitments.*

Note that we have attached a summary of the key details of the current 2012 and proposed 2013 MSOP evaluation framework under ISS's MSOP Policy at the back of this Alert.

Board Response to Majority-Supported Shareholder Proposals

ISS is proposing to recommend *Against* or *Withhold* from the entire board (except new nominees, who should be considered *case-by-case*) if the board failed to act on a shareholder proposal that received the support of a majority of shares cast in the prior year.

Request for Further Comment

ISS is seeking comment on the following:

- Are there any circumstances where a board should not implement a majority-supported proposal that receives support from a majority of votes cast for one year? If yes, please specify.

Comments Sought From Investors

- How would your organization vote on directors who failed to implement a shareholder proposal that received majority support in the previous year (vote against the full board; vote against the governance committee; other)?
- Would a commitment from the company for future implementation of a shareholder proposal that received majority support of votes cast in the previous year be acceptable?

Exequity Comment: *ISS's current policy requires that a shareholder proposal receive a majority shareholder vote two years in a row before ISS will recommend* Against *or* Withhold *from directors. According to ISS, this change in policy might have caused it to recommend* Against *or* Withhold *from* *directors at 24 additional companies in 2013 if they do not fully implement the shareholder proposals that received majority support in 2012. This policy change would increase the stakes for companies and likely could result in more companies challenging shareholder proposals in the future. Given the small number of potential negative vote recommendations that might be implicated by this change in policy for 2013, we believe the proposal will have more of an impact on the front end of the shareholder proposal process, i.e., in companies working with shareholders to retract their proposals. Also, as companies continue their outreach efforts with shareholders, certainly some focus will be on talking through areas of concern so shareholders are less likely to submit a shareholder proposal.*

SOGP Proposals

ISS is proposing to overhaul its SOGP policy to (1) include existing change-in-control (CIC) arrangements maintained with named executive officers (i.e., grandfathered arrangements that might have excise tax gross-up provisions) rather than focusing only on new or extended arrangements, and (2) place further scrutiny on multiple legacy problematic features in CIC arrangements.

According to the proposed policy, the following could cause ISS to recommend *Against* a company's SOGP proposal:

- Single- or modified single-trigger cash severance;
- Single-trigger acceleration of unvested equity awards;
- Excessive cash severance (>3x 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);
- Recent amendments that incorporate any problematic features (such as those above) 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; or
- The company's assertion that a proposed transaction is conditioned on shareholder approval of the SOGP proposal.

Request for Further Comment

ISS is seeking comment on the following:

- In your organization's view, when evaluating payments arising from problematic pay practices in the context of a SOGP proposal, would you differentiate between new and existing arrangements when determining whether to support the proposal? If yes, please specify.
- Would the number of problematic features be a consideration when evaluating a SOGP proposal? If yes, please specify.
- Are there any other factors that should be considered in evaluating SOGP proposals? If yes, please specify.

Exequity Comment: *It appears that ISS's proposed changes to this policy are motivated by its review of the 94 SOGP votes held during 2012 that it reviewed. ISS found that only 10 companies (10.6%) had no problematic pay practices, while 84 did (45 companies had only one problematic pay practice, 36 companies had only two problematic pay practices and 3 companies had only three problematic pay practices). Whether companies will take a harder look at eliminating their grandfathered provisions solely as a result of the change in policy to SOGP remains to be seen. ISS noted that the average support for the SOGP proposals in 2012 was approximately 81% (far less support than the 91% support companies receive on MSOP); however, the underlying transaction received average shareholder support of 95%. This indicates that shareholders are not letting their potential displeasure for the golden parachute arrangements get in the way of ultimately supporting the transaction. A few SOGP proposals have failed, and it appears that the primary concern with these proposals was the company's decision to modify the arrangements coincident with the transaction. Thus, shareholders may not have as much concern about grandfathered provisions as they do about enriching executives in the wake of a transaction. Nevertheless, if ISS does modify its SOGP policy, companies should look at their grandfathered arrangements and determine what they will do (if anything) if it looks like ISS will start to issue more negative vote recommendations based on grandfathered arrangements, as well as the shareholder vote consequences of such action.*

Environmental and Social Non-Financial Performance Compensation-Related Proposals

ISS is proposing the following changes to its existing policy on shareholder proposals addressing environmental and social non-performance metrics. The proposed policy would:

- Modify the general position of the policy from "Generally vote *Against*" to "Vote *case-by-case.*"
- Replace the listing of specific social and environmental criteria with a general reference of sustainability criteria and clarify that sustainability refers to environmental and social issues.
- In evaluating the factors it will consider, evaluate whether the company has significant and/or persistent controversies or violations regarding social and/or environmental issues (which is a change from "significant and persistent").

Request for Further Comment

ISS is seeking comment on the following:

- Would your organization consider factors in addition to those currently considered by the policy when a proposal requesting the addition of environmental and social non-financial performance measures to an executive compensation plan is being evaluated? If yes, please specify.
- Does your organization make a distinction between proposals requesting the addition of environmental and social non-financial performance measures to executive compensation plans and those proposals that request a report on linking, or on the feasibility of linking, environmental and social non-financial performance measures to executive compensation plans? If yes, please specify.

Exequity Comment: *This proposed policy change is subtle, but potentially significant, particularly when considered in conjunction with ISS's proposed policy change with respect to actions it will take if the board does not implement shareholder proposals that received majority support in the previous year. We believe it marks ISS's willingness to begin to see how its subscribers want environmental, social, and governance (ES&G) issues to be addressed in companies' pay programs. The ES&G movement has* *been increasing over the past decade. The fact that ISS would now consider such proposals on a case-by-case basis instead of generally opposing such measures signals a change in its approach to ES&G issues. Since ISS typically only makes such policy shifts when it becomes clear that its subscribers are already headed in a direction that supports such a change, this might signal the mainstreaming of ES&G issues in the context of executive compensation plans. If this policy change is adopted, more companies should evaluate whether they have any potential ES&G issues that shareholders might want to see linked to executive pay plans and determine whether it makes sense to try and address such issues before being raised by shareholders.*

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Proposed Changes to ISS Evaluation of MSOP Proposals

Factor	2012 Policy	Proposed 2013 Policy
Peer Group	• Peer group consists of between 14 and 24 companies with reference to the company's industry GICS classification, revenue (or assets for financial companies), and market value • Revenue—Between .45x and 2.1x the company's revenues • Total Assets—Between .45x and 2.1x the company's assets • Market Cap—Between .2x and 5x the company's market cap • Prioritization of selections are companies that: — Are in the company's 6-digit GICS group (up to 24 companies can be selected from the 6-digit GICS) If 14 companies cannot be selected from the 6-digit GICS group, the process is repeated first going out to the 4-digit GICS group, and then to the 2-digit GICS group • Exceptions: — Super-mega non-financial companies (over $50B in revenue and at least $30B in market value)—about 25 companies in this group who will be compared to one another — Other companies with fewer than 14 generated peers—revenue parameter is relaxed — ISS adjusts where certain selected comparators appear inappropriate (e.g., bankruptcy of a comparison company)	• ISS also will reference the company's selected peers' GICS industry groups • Revenue, Total Assets, and Market Value size criteria may be relaxed at very small and very large companies and revenue may be used instead of assets for certain financial companies • Prioritization of selection are companies that: — Are in the same 8-digit GICS classification as the company and the company's peers; — Are in the company's own self-selected peer group; and — Peer company also chose the company as a peer • If 14 companies cannot be selected from the 8-digit GICS group, the process is repeated first going out to the 6-digit GICS group, and then to the 4-digit GICS group • 2-digit GICS will not be used • Resulting peer group should: — Maintain the company near the median of the peer group; and — Maintain the approximate proportions of the GICS industry groups as in the self-selected peer group • Exceptions: None specified
Relative Degree of Alignment (RDA)	Measures alignment of TSR and CEO pay to peer group on a 1- and 3-year basis (weighted 40%/60%, respectively)	Same as 2012
Relative Multiple of Median (MOM)	Measures CEO pay as a multiple of the peer group's median CEO pay	Same as 2012
Pay-TSR Alignment (PTA)	Measures the alignment of a company's CEO pay and TSR over the past 5 years	Same as 2012

Factor	2012 Policy	Proposed 2013 Policy
Qualitative Analysis	• Ratio of performance- to time-based equity awards • Overall ratio of performance-based compensation • Completeness of disclosure and rigor of performance goals • Company's peer group benchmarking practices • Actual results of financial/operational metrics, such as growth in revenue, profit, cash flow, etc. both absolute and relative to peers • Special circumstances related to, for example, a new CEO in the prior fiscal year or anomalous equity grant practices (e.g., biannual awards) • Any other factors deemed relevant	Realizable pay compared to grant pay for large-cap companies added to the list
Definition of Realizable Pay	N/A	• Actual cash compensation • Actual equity earned (options exercised, shares vested) • For ongoing equity awards, target values adjusted for the stock price at the end of the performance measurement period • Performance measurement period not specified • Relative versus absolute not addressed
Problematic Pay Practices	• Repricing or replacing underwater stock options/SARs without prior shareholder approval (including cash buyouts and voluntary surrender of underwater options) • Excessive perquisites or tax gross-ups, including any gross-up related to a secular trust or restricted stock vesting • New or extended agreements that provide for CIC payments exceeding 3x base salary and average/target/most recent bonus, CIC severance payments without involuntary job loss or substantial diminution of duties ("single" or "modified single" triggers), or CIC payments with excise tax gross-ups (including "modified" gross-ups)	Pledging of company stock added to the list