Securities Alert: ISS Issues 2013 U.S. Corporate Governance Policy Updates

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On November 16, 2012, Institutional Shareholder Services Inc. (ISS) released the 2013 Updates to its U.S. Corporate Governance Policy (the 2013 Updates). The 2013 Updates will be effective for shareholder meetings on or after February 1, 2013, unless otherwise noted below. The key highlights of the 2013 Updates are summarized below. ISS will release revised FAQ documents in December 2012 that provide additional guidance related to some of the new policies. We also understand that ISS plans to hold a webcast on the 2013 Updates on December 6th.

We will be discussing the 2013 Updates at our complimentary seminar, *Preparing for the 2013 Proxy and Annual Report Season*, to be held in January of 2013. For more information on this seminar, please contact Kayla Allen at ksallen@vorys.com.

Issues Affecting Advisory Votes on Executive Compensation

Investors continue to rank executive compensation as the top corporate governance topic. The 2013 Updates to the pay-for-performance evaluation undertaken in advance of an advisory "say-on-pay" vote on executive compensation refine how the subject companies' peer groups are selected, adjusting the criteria in an effort to include within the relevant peer group companies that have more in common with the subject company. The 2013 Updates also add the concept of "realizable pay" to the qualitative analysis for large cap companies.

Peer Groups

The 2013 Updates generally retain the methodology used by ISS in 2012 to evaluate a say-on-pay proposal, utilizing both a quantitative and qualitative analysis to assess the alignment between pay and performance and determine the recommendation of ISS on the proposal. As part of the quantitative analysis, the previous methodology focused the selection of a peer group on the subject company's Global

Industry Classification Standard ("GICS") industry group. The GICS classification, however, does not always capture the multiple business lines in which a company operates, which may lead to the omission of direct competitors from a company's peer group or the inclusion of companies without much relation to the business of the subject company.

The 2013 Updates expand the scope of companies selected for a peer group. Instead of relying on only the company's GICS classification, the 2013 Updates provide for use of the peers from the subject company's GICS group as well as from GICS industry groups represented in the peer group the company has self-selected in benchmarking its executive compensation, while maintaining approximate proportions of these industries in the final peer group. The new methodology additionally focuses initially at an 8-digit GICS level rather than more specific levels, to be better aligned in terms of industry. ISS will prioritize for inclusion peers that (a) maintain the subject company near the median of the peer group in revenue/asset size, (b) are in the subject company's peer group and (c) have chosen the subject company as a peer. ISS' selection criteria will continue to focus on companies that are reasonably similar in industry profile, size and capitalization.

Other changes to the peer group methodology include using slightly relaxed size requirements, especially at very small and very large companies, and using revenue instead of assets for certain financial companies.

Realizable Pay

The 2013 Updates expand the list of qualitative factors used to analyze pay-for-performance alignment at large cap companies to include "realizable pay", which may ultimately mitigate or exacerbate pay-for-performance concerns. While the grant date pay disclosed in a company's Summary Compensation Table reflects the intent of the Compensation Committee's pay decisions, it does not necessarily reflect the final payouts of performance awards or changes in value due to gains or losses in the subject company's stock price.

Realizable pay will consist of the sum of relevant cash and equity-based grants and awards made during the specific 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. Stock options and SARs will be re-valued using the remaining term and updated assumptions, as of the performance period, using the Black-Scholes option pricing model.

Golden Parachute Proposals

The Dodd-Frank Act requires companies to hold separate shareholder votes on potential "golden parachute" payments when they seek approval for mergers, sales and certain other transactions. In determining the recommendation with respect to a golden parachute proposal, the 2013 Updates include the consideration of any existing change-in-control arrangements maintained with named executive officers, rather than focusing only on the new or extended arrangements. The list of features considered problematic has been refined. Recent amendments that incorporate problematic features will tend to carry more weight in the overall analysis. However, close scrutiny will also be given if multiple legacy problematic features are present.

Issues Affecting Votes on Director Nominees in Uncontested Elections

Hedging and Pledging

Current ISS policy provides for the recommendation of a negative vote for directors, whether individually or as part of a committee or the entire board, due to material failures of risk oversight at the company. The 2013 Updates expand the examples of a failure of "risk oversight" to include, among other things, the hedging of company stock and the significant pledging of company stock as collateral for a loan. These practices are seen as severing the alignment of interests between the officers and directors and the shareholders. Hedging of company stock at any level and in any form poses enough of a problem to warrant a negative vote recommendation. For companies in which officers or directors have pledged company stock as collateral, ISS considers the following factors in determining vote recommendations for the election of directors:

- Presence in the company's proxy statement of an anti-pledging policy that prohibits future pledging activity;
- Magnitude of aggregate pledged shares in terms of total common shares outstanding or market value or trading volume;
- Disclosure of progress or lack thereof in reducing the magnitude of aggregate pledged shares over time;
- Disclosure in the proxy statement that shares subject to stock ownership and holding requirements do not include pledged company stock; and
- Any other relevant factors.

Majority Supported Shareholder Proposals

As the expectations of institutional investors, and the responsiveness of issuers, regarding majority supported shareholder proposals continue to advance, ISS has adjusted its policies accordingly. Beginning with board elections in 2014, ISS will recommend a negative vote on individual directors, committee members or the entire board, as appropriate, when the board has failed to take sufficient action on a shareholder proposal that received the support of a majority of the shares cast on such proposal in the previous year.

The 2013 Updates allow for greater flexibility in recommending a vote against only certain board members, rather than the full board. The 2013 Updates also provide more guidance for evaluating the sufficiency of a company's response to a majority supported shareholder proposal. Responses that involve less than full implementation of the proposal will be evaluated on a case-by-case basis, considering the following the factors:

- The subject matter of the proposal;
- The level of support and opposition provided to the resolution in past meetings;
- Disclosed outreach efforts by the board to shareholders in the wake of the vote;
- Actions taken by the board in response to its engagement with shareholders;

- The continuation of the underlying issue as a voting item on the ballot (as either shareholder or management proposals); and
- Other factors as appropriate.

The revised FAQs to be issued by ISS in December may provide more guidance with respect to the implementation evaluation.

Overboarded Directors

Current ISS policy recommends a negative vote on directors who are CEOs of other public companies and sit on board of more than two public companies besides their own – with the withhold recommendation only covering their outside boards. The 2013 Updates eliminate the previous exception that counted the boards of a public company parent and its public company subsidiary as a single board so long as the parent owned at least 20% of the subsidiary. The 2013 Updates now count these parent and subsidiary boards as two separate boards.

Shareholder Proposals Addressing Social and Environmental Issues

Environmental, Social, and Governance Compensation-Related Proposals

The 2013 Updates modify ISS policy from generally recommending a vote against to making a vote recommendation on a case-by-case basis with respect to proposals that link executive compensation to sustainability criteria, including various environmental and social criteria. As these non-financial performance metrics become more common among certain industries, specifically the extractive industry sectors, and are increasingly addressed in international investor initiatives, the 2013 Updates recognize the increasing interest of institutional investors in sustainability issues as part of the evaluation process.

Lobbying

The 2013 Updates provide for vote recommendations on a case-by-case basis when evaluating proposals requesting information on a company's lobbying activities. The 2013 Updates clarify the scope and focus of lobbying activities covered, adding indirect lobbying activities as well as lobbying procedures and principles to the list that previously included only direct lobbying and grassroots lobbying within the specific policy.
