# Executive Compensation Alert:

## ISS Proposed 2013 Proxy Voting Guidelines for Say-on-Pay

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On October 18, 2012, Institutional Shareholder Services, Inc. ("ISS") released proposed updates to its voting policies for U.S. companies for the 2013 proxy season. The update highlights ISS's methodology for evaluating shareholder advisory vote proposals on Say-on-Pay as required under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"); as well as how ISS will evaluate Say-on-Parachute shareholder advisory votes that are required in connection with corporate mergers and other change of control transactions. The proposed changes can be viewed and commented upon at the ISS website (www.issgovernance.com). The comment period ends October 31.

ISS's updated policies will be finalized in December 2012 and effective for shareholder meetings held after February 1, 2013.

**Background**

ISS is proposing to change four inputs to the executive compensation policies used during the 2012 Proxy Season for purposes of formulating a recommendation on a company's advisory Say-on-Pay and Say-on-Parachutes proposals in 2013:

- incorporating information about a company's *self-selected* peers into ISS's methodology for selecting peer groups as part of its quantitative pay-for-performance analysis;
- including a comparison of "realizable" pay to grant date pay as part of its qualitative pay-for-performance analysis at large cap companies
- requiring that companies state their policy on pledging of shares and proposing that the absence of such a policy may be a negative qualitative factor in assessing executive compensation; and
- reviewing *existing* change of control arrangements maintained for executives in the context of making recommendations on a company's Say-on-Parachutes shareholder advisory vote.

**Peer Group Methodology**

ISS's construction of peer groups was a controversial topic during the 2012 proxy season in the context of Say-on-Pay recommendations. ISS conducted its quantitative analysis of pay-for-performance by assessing 8-12 of a company's peers selected on the basis of market capitalization, revenue, and GICS industry group (Global Industry Classification Standard, or GICS, categorizes companies based on two-digit "sector" codes, four-digit "industry group" codes, six-digit "industry" codes and eight-digit "sub-industry" codes). ISS came under criticism largely because it ignored the company's own self-selected compensation peer group. For example, ISS's 2012 GICS industry classification methodology did not reflect multiple business lines in which the company operates, sometimes leading to the exclusion of a company's competitors from, or the inclusion of inappropriate comparisons in, the ISS peer group.

Under ISS's proposed 2013 voting policy changes, the peer group will consist of 14-24 companies that are selected based on size and inclusion in the same GICS industry group. The primary size determinants will include market cap and revenue and the market cap component would reflect the company's life cycle maturity phase (no guidance on how this concept would be implemented in 2013). More importantly, the 2013 policy incorporates information about a company's self-selected peers to improve this relative comparison. The proposed change in methodology draws peers from GICS classifications represented in the company's self-selected peer group, while maintaining the approximate proportions of these industries in the ISS peer group where possible. It is not yet clear how ISS will incorporate this information in 2013.

**CEO Pay Alignment**

*Relative Alignment*. Unlike in 2012, where there was a lack of correlation between CEO pay alignment and relative TSR (total shareholder return), in 2013 CEO pay alignment would be evaluated based on one- and three-year relative TSR and the year-over-year change in CEO pay. Thus, the 2013 policy would evaluate both CEO pay and TSR on a relative basis over one and three years.

*Absolute Alignment*. In 2013, CEO pay alignment will also be evaluated as it was in 2012 (on an absolute basis against TSR over a five-year period). However, in 2013 the analysis will assess the difference in the rate of change of annual pay vs. the rate of change of annual TSR.

*Realizable Pay*. If ISS's quantitative pay-for-performance analysis demonstrates "weak" alignment, then ISS will perform a further qualitative review that takes into account a broad range of factors, including the use of performance-based awards, performance goals, peer group benchmarking, and financial performance. This qualitative review will add realizable pay as compared to grant pay as one of these factors for large cap companies. "Realizable pay" consists of the sum of cash and equity-based grants and awards made "and earned" during the specified performance period being measured, or target values for ongoing awards, using the stock price at the end of the measurement period. It is almost certain that in 2013 company proxies will undertake to compare performance to realizable pay whenever appropriate.

### Pledging of Shares

ISS is proposing adding pledging of company stock by executives or directors to its list of problematic practices. ISS believes Say-on-Pay proposals are a reasonable mechanism for shareholders to voice concern with companies' pledging policies.

### Say-on-Parachutes

Companies that seek shareholder approval for corporate mergers and other change of control transactions are required by Dodd-Frank to request a shareholder advisory vote on change-in-control payments to executives. ISS's policy on Say-on-Parachute votes continues to evaluate proposals on a case-by-case basis and take into account the factors set forth in ISS's existing policies. The proposed 2013 voting policy; however, includes a focus on all *existing* change-in-control arrangements with executive officers, rather than focusing only on new or extended arrangements as under its current policy. In addition, ISS's proposed 2013 policy considers factors such as, single-or modified-single-trigger payment and excessive golden parachute payments on an absolute basis and as a percentage of transaction equity value basis.

Since relatively few companies (less than 200) have been required to schedule such a Say-on-Parachute vote, and only a fraction of those companies have received negative ISS recommendations, there is insufficient data to consider the impact of ISS's proposed policy change on Say-on-Parachutes votes.

**For more information, you may contact any attorney in the Executive Compensation and Employee Benefits Group at Fenwick & West LLP.**

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