

CLIENT ALERT

A Preview of Key Executive Compensation Issues for the 2014 Proxy Season
Results of ISS' 2013-2014 Policy Survey

ISS recently released the results of their annual survey of institutional investors and companies on emerging corporate governance issues. ISS considers the survey a critical component of its annual policy review and formulation process.

In contrast with last year's survey which focused on numerous executive compensation topics (e.g. peer group selection, measuring pay including granted vs. realizable pay, pay for failure, and executives' and/or board members' pledging of company stock), this year's survey concentrated on broader high-level corporate governance themes including board responsiveness, director tenure/rotation and director assessment, with the primary executive compensation survey questions relating to equity plan evaluations. One theme that continued from last year's survey results: the sometimes dramatic differences in opinions held by those in the investment community vs. companies.

Some of the key results for the U.S. market include:

Equity Plans

Survey questions focused on whether ISS should take a more holistic approach to the evaluation of equity-based compensation plans. Investor respondents agreed with this approach, as a majority indicated that performance conditions, plan cost, and features such as vesting requirements, change in control provisions, and repricing provisions are "very significant" factors in evaluating equity plans. Companies rated these issues as only "somewhat significant." Interestingly, companies and investors also agreed that relative TSR was only "somewhat significant" in this context. Plan administration items, such as burn rate and prior repricing history, were viewed by both investors and companies as "somewhat significant."

It appears that ISS is responding to this investor feedback, as senior ISS employee announced at the recent NASPP conference, an equity plan "scorecard" is likely to be implemented for the 2015 proxy season. ISS also announced "minor" modifications to the Relative Degree of Alignment (RDA) metric to be used in Pay for Performance evaluation and peer construction methodology for 2014.

Board Responsiveness

Survey questions on this topic focused on the issue of board responsiveness to non-binding shareholder mandates. Not surprisingly, an overwhelming majority (92%) of companies responded that the board should be free to exercise its discretion to respond in a manner consistent with the best interests of the company and to disclose the rationale for any actions it takes. Investors' responses were mixed, with 40% agreeing with companies that the board should use its discretion, while 36% believed the board should implement a specific action to address the shareholder mandate. A significant minority (24%) of investors believes it depends on the circumstances, primarily focusing on the level of shareholder support (or dissent), on the issue.



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Director Tenure

The policy survey asked for feedback regarding the length of director's tenure and rotation of Board members. Significant divergence was found on this topic, as the vast majority of company respondents (84%) do not view director's tenure as potentially problematic. Companies also strongly believe that ISS should not consider a policy that takes into account director rotation for board chair, lead director or chairs of board committees.

Investors voiced concerns regarding long tenure, as 74% indicated that long tenure is problematic. Ten years was the most common response from investors regarding the length of board service that would call into question the director's independence (companies peg this number at 15%). Over half of investors also encouraged rotation of key positions such as board chair (52%), lead director (57%) and committee chairs (57%).

Director Assessment

Both investors and companies agree that a Director's current or prior service on the Boards of other public companies should be a major factor in assessing director performance. Specific factors deemed critical in assessing a Director's service on other public company Boards include the breadth of experience, relevant expertise and governance concerns at other public Boards.

Role of Company Performance in Director Evaluation

A slight majority of investors (54%) believe that ISS should always consider company performance when evaluating Directors, while a significant minority of investors (36%) believes that ISS company performance should be considered when a company exhibits problematic governance practices. Financial metrics, such as ROE, ROA, ROIC, EPS and margins, were cited by investors almost as frequently as TSR as key performance metrics in evaluating director performance. As a strong proponent of the need for investors to assess financial and operational performance in addition to TSR, we are delighted to see that investors are interested in taking a more holistic approach on this issue.

Companies took a more nuanced view in evaluating Directors as only 25% believe that ISS should always consider company performance. The majority of company respondents believe that ISS should consider company performance in the event that a company exhibits problematic governance practices, only in specific instances, or not at all.

Company respondents that believed ISS should always take performance into account were in agreement with investors on appropriate metrics financial (79%) and relative TSR (74%) when evaluating directors. Both investors and companies also cited 3-5 years as an appropriate time-frame in assessing a board member relative to company performance.

Differentiation of Policy by Size or Type of Company

Slightly more than half of investors believe it is appropriate to differentiate policy by company size or type for equity compensation evaluations. However, differentiation policies for Chairman/CEO separation, presence of key Board committees, minimum level of Board independence and limits on general share issuance authorizations all received less than majority support.



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Interestingly, companies viewed differentiation policies more favorably, particularly for equity compensation (73%), chairman/CEO separation (62%), and share authorization limits (58%).

For those respondents in favor of differentiation, both investors and companies agreed that market capitalization size is an appropriate way to differentiate.

Investors did not believe that ISS should apply more lenient standards for smaller or IPO companies, which contrasted markedly with views from company respondents. A significant majority of companies (67%) indicated that ISS should apply more lenient policy guidelines for small or IPO companies.

Share Authorizations and Issuances

Investors deem size of the requested share increase (77%), ratio of current shares outstanding to the new authorization (73%), company's stated use of shares (71%), governance structure and practices (54%) and historical use of shares (49%) to be "very important" when assessing proposals seeking increases in authorized share capital. For company respondents, only the ratio of current shares outstanding to the new authorization (50%) and size of the requested share increase (48%) received close to majority support as "very important" factors.

The complete study can be found [here](#).

Key Takeaways

Companies should evaluate current and planned shareholder outreach efforts to ensure that they reflect and are responsive to the preferences and concerns of their shareholders, as highlighted in this survey. Materials should be tailored to acknowledge this perspective, and where company policy differs from known or anticipated investor positions, clear and convincing rationale describing how the company's position is in the best interests of shareholders should be provided.

As the survey represents a significant part of ISS' annual policy review, we will likely see these themes reflected in the draft 2014 policy updates which will be released in November. The subsequent comment period will provide another opportunity for companies to weigh in with their views on these topics.

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