SEC Issues Proposed Rules Regarding Disclosure of Hedging Rules; ISS and Glass Lewis Release New Documents Regarding Executive Pay Policies

By: John Ellerman and Linda Pappas

Introduction

The Securities and Exchange Commission (SEC) has just released its proposed rules regarding the requirement for companies to report as to whether employees and non-employee directors are allowed to hedge or offset the decrease in market value of equity securities. This disclosure requirement has been mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") legislated in late 2010. The SEC is seeking public comment on the proposed rules for 60 days ending on April 20th.

Proxy advisory firm Institutional Shareholder Services (ISS) has just released a new document explaining the firm's latest policies with respect to executive compensation, including its say on pay advisory voting services. This new publication is in the form of 104 questions and answers (Q's and A's) and should serve as a good reference document for companies considering the ISS policy position on certain executive compensation issues.

Another proxy advisory firm, Glass, Lewis & Co. LLC (Glass Lewis), has implemented changes to its pay for performance and equity plan models. The changes to the pay for performance and equity plan models includes enhancements to the performance metrics used in both models. The changes made by Glass Lewis are effective immediately and will impact the firm's advisory voting services with respect to say on pay.

Pay Governance provides a brief overview of these developments in the following paragraphs.

Key Findings

1. The SEC has released proposed rules regarding the Dodd-Frank requirement for companies to disclose their policies regarding the hedging of company securities by their employees and directors. The SEC proposes to implement Section (j) of the Securities Exchange Act of 1934 by requiring disclosure in any proxy statement on Schedule 14A or information statement on Schedule 14C of company hedging policies. Per usual practice, the SEC has opened a 60 day comment period to the proposed rules.

2. ISS has produced a new document further clarifying its policy position on executive compensation issues for the 2015 proxy season. The document is in the form of 104 questions and answers (Q's and A's). We have identified 20 Q's and A's and have highlighted in an Exhibit those policy issues where ISS provides a change, modification, or clarification to an existing policy.

3. Glass Lewis has announced changes to its pay for performance and equity plan models. The changes include the removal of one of its performance metrics with a new metric for companies that are in either the banking, diversified financial services, insurance, or REIT industry sectors. Glass Lewis states that it has tested the new performance metrics for these industry sectors and expects that the changes will have limited impact on their say on pay votes going forward.

Proposed Rules – Disclosure of Policies Regarding Hedging of Company Securities

The Dodd-Frank financial reform legislation was enacted more than four years ago, and following its passage the SEC was directed to develop various rules and regulations pursuant to the implementation of the law. One such area requiring SEC development is the subject of disclosure of companies' policies regarding hedging transactions by employees and directors in company securities.

The SEC has proposed rule amendments to implement Section 955 of Dodd-Frank which adds new Section 14(j) to the Securities Exchange Act of 1934. Section 14(j) directs the SEC to require, by rule, each filing company to disclose in any proxy or consent solicitation material for an annual meeting of shareholders whether any employee or director or their respective designees "is permitted to purchase financial instruments (including prepaid variable forward contracts, equity swaps, collars, and exchange funds) that are designed to hedge or offset any decrease in the market value of equity securities either (1) granted to the employee or director by the issuer as part of the compensation of the employee or director; or (2) held, directly or indirectly, by the employee or director." The SEC proposes to implement Section 14(j) by adding new paragraph (i) to Item 407 of Regulation S-K to require companies to disclose whether they permit employees and directors to hedge their company's securities.

The proposed amendments implementing Section 14(j) will require the disclosure in any proxy statement on Schedule 14A or information statement on Schedule 14C. The issuer is requested to clarify that the term "employee" includes officers of the company. The Dodd-Frank Act refers to hedging by employees, not officers, and the rule requires the issuer to affirm that their policies apply to the officers of the company.

As advisors to corporate America with respect to executive compensation, Pay Governance consultants find that the vast majority of companies have already implemented anti-hedging policies with respect to their employees and directors. Therefore, we expect that this new rule by the SEC will only be a requirement for most issuers to simply disclose their existing policies as a new annual reporting requirement.

ISS Policy Clarification for 2015 Proxy Season

On February 9, 2015 ISS released its new document which provides extensive clarification, in the form of frequently asked questions and answers, to its compensation policies applicable to U.S. companies holding annual meetings on or after February 1, 2015. More than one-half of the Q's and A's are devoted to ISS policies regarding the management say on pay evaluation conducted by ISS on behalf of institutional investor clients. In particular, the document explains both the quantitative and qualitative pay for performance analysis, how ISS determines peer companies for benchmarking pay and company performance, and those compensation policies of an issuing company which it considers to be problematic.

Pay Governance has reviewed the new policy clarification document from ISS. Based upon our review, we have identified 20 Q's and A's which represent changes or modification of existing ISS policies. In certain instances, ISS has introduced a new Q and A to identify a new policy initiative adopted by the firm. To assist you in reviewing the scope and magnitude of the changes and restatements adopted by ISS with respect to its policies for the 2015 proxy season, PG has prepared the attached Exhibit. The Exhibit identifies the policy issue, type of change, and detailed description of the change prescribed by ISS.

In the Exhibit, you will find that the changes in policy specified by ISS are not of major magnitude but instead represent further clarification to their previously stated policies. ISS appears to be making a commitment to its policy of providing increased transparency to its executive compensation policies.

Glass Lewis Changes to Pay for Performance and Equity Plan Models

Proxy advisor Glass Lewis has implemented changes to the performance metrics used in its U.S. and Canadian pay for performance models and its U.S. equity plan model, effective February 2, 2015. The changes made by Glass Lewis are an attempt to improve the models' ability to assess performance of companies in certain industry sectors.

Previously, Glass Lewis models measured universally the following five performance metrics: change in operating cash flow, change in earnings per share, total shareholder return (TSR), return on equity, and return on assets. Going forward, Glass Lewis has revised its metrics for banks, diversified financials, and insurance companies by replacing the metric of change in operating cash flow with tangible book value per share growth. In addition, companies which are real estate investment trusts (REITs) other than mortgage and specialized REITs will be analyzed by replacing the metric of change in operating cash flow with the new metric of growth in funds from operations.

Glass Lewis has stated that it has tested the changes to the performance metrics on a historical basis and believes that the changes will have minimal impact on its pass/fail assessments for say on pay advisory votes.

Conclusions

As the new proxy season approaches, the proxy advisory firms ISS and Glass Lewis have provided additional guidance as to their approaches and policies in reviewing executive compensation and say on pay advisory votes. Both firms have added minor changes to their policies in an attempt to assist companies in interpreting their policies as companies prepare their new proxy disclosures. We welcome transparency and policy changes that appear to better reflect industry fundamentals; however, we are disappointed that both firms issue these updates with little or no advance notice prior to their effectiveness. The SEC has finally produced proposed rules regarding the disclosure of pledging policies by corporate issuers and has opened a 60 day comment period, which will unlikely have a material impact given most companies have already adopted these policies (and both ISS and Glass Lewis lack comments on these policies).

General questions about this Viewpoint can be directed to John Ellerman or Linda Pappas by email at john.ellerman@paygovernance.com or linda.pappas@paygovernance.com.

Exhibit A

ISS 2015 FAQ		Type of Change	Detailed Description of Change
US Executive Pay Overview			
3	How is Total Compensation calculated?	Modified portion of response	"Performance shares (equity incentive plan awards) may be calculated at target value (# of shares X stock price on grant date) if it differs from the value disclosed in the grants of plan-based awards table (GPBAT)." (*previous approach was to use the as disclosed values for performance shares*)
Management Say on Pay (MSOP) Evaluation			
15	If a company has an MSOP resolution on the ballot, will ISS also apply compensation-related recommendations to members of the compensation committee who are up for election?	Modified portion of response	ISS added that they may recommend withhold/against votes not only to compensation committee members, but also to the entire board, if it deems appropriate
17	A company stated in a past year that it adopted biennial or triennial frequency for MSOP resolutions but fails to put the proposal on the ballot in the next expected year. What action is warranted under ISS policy?	Q&A new in 2015	ISS indicates that failure to provide a SOP vote at the relevant meeting may result in against or withhold recommendations against incumbent Compensation Committee members or, in exceptional circumstances, the full board. They also recommend that companies should provide explanation about the timing of the next SOP resolution
18	If one or more directors received a negative recommendation in the prior year due to ISS' concern over compensation practices will it have a bearing on the following year's recommendation?	Modified portion of response	ISS clarified that the prior year recommendation is not a specific consideration in the following year's analysis (although the underlying concern may be)
Pay for Performance Evaluation			
22	How does the initial quantitative pay for performance analysis affect the ultimate vote recommendation for Management Say on Pay proposals or election of compensation committee members (in the absence of management say on pay proposal)?	Modified portion of response	Added 2014 proxy season statistics which indicate the mix for companies receiving high concern on the quantitative tests was approximately 56% "against" and 44% "for"
40	A company grants time-based stock awards after meeting specific performance criteria. Does ISS consider such awards to be performance contingent compensation?	Rephrased response	ISS indicates that ISS *will* generally consider such awards to be performance-contingent if the performance measures and goals were pre-established and are disclosed in the proxy statement

	ISS 2015 FAQ	Type of Change	Detailed Description of Change
42	Which companies are subject to ISS quantitative pay-for-performance screens?	Q&A new in 2015	As of 2015, NEO pay is collected and CEO pay is analyzed in the quantitative screens, for all companies in the S&P500 and Russell 3000E indexes. The latter includes all Russell 3000 and Russell Microcap Index companies *(the Russell Microcap Index companies are new for 2015)*
43	How does ISS evaluate pay-for-performance alignment at companies for which pay data is not analyzed in the quantitative screens?	Q&A new in 2015, but practice is not new	ISS reviews the compensation discussion & analysis (CD&A), summary compensation table (SCT) and other compensation tables to assess the level of NEOs' pay relative to internal standards to identify potential egregious pay levels and problematic compensation practices
DETERMINING PEER COMPANIES			
45	Will a company's self-selected peers always appear in the ISS peer group, if they meet ISS' size constraints?	Modified portion of response	If a company's self-selected peer is the only peer company in its 6- and 8-digit GICS category, that industry grouping <u>will not be utilized</u> in the peer selection process *(ISS previously stated that the industry grouping would receive lower priority)*
46	What are ISS' size parameters for qualifying a potential peer?	Modified portion of response	Market cap is now used for certain oil & gas companies as a size constraint *(in place of revenue)*
47	Which industry groups will not use revenue for size comparisons? What happens when a company has potential peers in both asset-based and revenue-based industry groups?	Modified portion of response	*(New for 2015)* ISS will apply only a market cap test to qualify peers for companies within the following GICS groups: Integrated Oil & gas, Oil & Gas Exploration & Production, Oil & Gas Refining & Marketing, Oil & Gas Storage & Transportation, Coal & Consumable Fuels
54	In December, ISS provides companies an opportunity to communicate any changes made to their benchmarking peer groups following their most recent proxy disclosures. Will companies with later fiscal year-ends that did not know at that time what changes they were making to peer groups used with respect to latest fiscal year compensation decisions also have an opportunity to communicate change?	Modified portion of response	*ISS added the following to clarify what information they are seeking*: "during the update process, companies should inform ISS of updates to the peer groups they used to benchmark executive pay that will be reported in their upcoming proxy (not to benchmark the upcoming year's pay)"
55	Can only Russell 3000 companies be used as peer companies? Will ISS use companies that an issuer considers as peers (specified in the proxy) to develop the ISS comparator group?	Modified portion of response	Beginning in 2015, ISS added the Russell Microcap Index to its database for compensation data (and to construct peer groups), which includes approximately 700 companies that are not also in the Russell 3000 Index

ISS 2015 FAQ		Type of Change	Detailed Description of Change
COST OF EQUITY PLANS			
79	What date does ISS use for the data used in equity plan analysis?	Q&A new in 2015, but practice is not new	ISS updates equity plan modeling inputs four times a year in its quarterly data download (QDD), which occurs on Dec 1, Mar 1, June 1, and Sept 1. The QDD used depends on the company's shareholder meeting date
BURN RATE			
87	What action may a company take if its three-year average burn rate exceeds ISS' burn rate benchmark (as considered under the Equity Plan Scorecard policy (EPSC))?	New response for 2015	*ISS has a new burn rate policy under the EPSC; the burn rate test is no longer "pass-fail"*—if company burn rate exceeds the optimal level, the company may seek to adopt relevant positive plan features and/or other grant practices that may compensate for the burn-rate shortfall
88	Since adoption of the EPSC, ISS no longer considers future burn-rate commitments, but what are the implications for companies that made burn-rate commitments in prior years to address excessive burn-rate under ISS' previous policy?	Q&A new in 2015	Companies must continue to adhere to previously made burn-rate commitments, or will otherwise be held accountable
LIBERAL SHARE RECYCLING			
97	What happens if a company provides a limit on the number of shares that it can recycle?	Modified response due to new EPSC policy	The new policy has separate factors related to option liberal share recycling and full-value share recycling
ACCELERATED VESTING			
98	What is ISS' view of accelerated vesting of awards upon a change in control?	Modified portion of response due to new EPSC policy	Reworded response slightly to be more in line with new EPSC policy, and also added new paragraph specific to the EPSC policy which indicates automatic single-trigger vesting is considered a negative factor; whereas *potential* accelerated vesting may be considered a negative factor when paired with a liberal change in control definition
PLAN DURATION			
102	How does ISS calculate the probable duration of a proposed equity plan share request?	Modified portion of response due to new EPSC policy	Probable duration is now a factor in ISS' EPSC policy, so it may have an impact on ISS' equity plan proposal recommendation
STOCK OPTION OVERHANG CARVE-OUT*			
104	When will ISS apply the stock option overhang carve-out policy?	Modified portion of response due to new EPSC policy	ISS will no longer consider overhang carve-outs; SVT is now measured based on two calculations: one that includes all outstanding unvested/unexercised awards (overhang) as in prior years, and one that excludes overhang and considers only newly requested shares and those that remain available from prior plan approvals

**ISS also removed several FAQs related to the previous overhang carve-out policy since it is no longer in effect due to the new EPSC policy*