

Call for Comments to Draft ISS Policy on Equity-Based Compensation (France)

AFEP (Association Française des Entreprises Privées) whose headquarters are in Paris 11, avenue Delcassé Paris 75008, represents at present more than 90 of the top private sector companies operating in France. The purpose of AFEP is to present the views of large French companies to the European Institutions and the French authorities, mainly with regard to the drafting of non-sectoral legislation (on the economy, taxation, company law, financial and accounting information, competition, intellectual property rights, consumer affairs, social regulations, employment legislation, environment, etc.).

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We appreciate the opportunity to comment on ISS's draft equity compensation policy applicable to French issuers. As set out herein, we believe that the proposed revisions include a number of important improvements but also contain some proposals which are either undesirable or unclear. We comment in turn each of the subjects which ISS has specifically identified in its call for comments published earlier this month, with the exception of one item specifically targeting companies that do not apply the AFEP-MEDEF code of corporate governance.

Increasing focus on performance criteria in line with local best practice.

The proposal appears to codify ISS's current practice in France, and from that point of view could be considered not to represent a significant change. However, we note that ISS does not appear to have codified a similar requirement in its policies outside of France (for example, the 2011 U.S. Proxy Voting Guidelines would permit non-conditional equity grants to corporate officers and directors, so long as other components of their remuneration worked to align pay with performance).

With respect to the persons subject to performance conditions, the AFEP-MEDEF code of corporate governance does not require that conditions be applied to all "executives"¹ and is specifically concerned with the application of performance criteria to a more limited class of corporate officer². It is true that a number of French issuers have voluntarily devised policies under which all grants to executives must be subject to performance conditions. While such policies are no doubt appropriate for these issuers, it must be said that they go beyond the requirements of the AFEP-MEDEF code of corporate governance and beyond what ISS requires elsewhere, which raises the question of why such a policy is proposed as a mandatory ISS requirement for France. We do not believe that this would be appropriate.

¹ Please note that the call for comments erroneously states that the AFEP-MEDEF code of corporate governance applies this requirement to executives.

² Dirigeants mandataires sociaux.

We note additionally that an ISS requirement for France that such conditions be quantified would also go beyond the requirements of both the AFEP-MEDEF code of corporate governance and the 2011 U.S. Proxy Voting Guidelines. While quantified conditions have the advantage of being fully transparent to shareholders and have been viewed as suitable for some companies, it is frequently the case that the incentives that a Board considers important to put in place within their companies and support with equity plans do not concern easily-publishable criteria. For example, a company cannot reasonably publish its targeted margins or budget for competitive reasons, but the Board may consider this to be the most pertinent target for corporate officers to achieve. To penalize these Boards for using the criteria they determine make sense for the company, or to reward them for using publishable criteria that they would not have considered suitable in the absence of the threat of a negative recommendation from ISS, does not favour responsible corporate governance.

The assessment process by ISS of all awards granted to executives based on a “challenging performance criteria” remains rather opaque. It would be useful to issuers and informative for investors for ISS to provide some more methodological background on how this assessment is made.

Raising the allowable volume ceiling to 10 percent of share capital for all companies

The proposal to eliminate the separate volume ceilings for so-called “growth” and “mature” companies by aligning with the 10 percent ceiling currently applicable to growth companies under ISS’s general policy eliminates a number of problematic points for the members of AFEP and is a very positive development.

First, the current use of “growth” and “mature” as the decisive criteria is problematic. There is no accepted definition of what is and is not a growth company, resulting in uncertainty as to which ceiling should be applied in a number of cases. Additionally, there are numerous other equally valid company-specific criteria that a company’s Board of Directors and shareholders could consider relevant to the determination of the appropriate level of potential dilution (*e.g.*, the degree to which existing plans are persistently out-of-the money, the length of vesting periods chosen by the Board, the need to have competitive conditions for talent, decisions as to the appropriate population for incentive programs, availability of cash, etc.), making the current policy a straightjacket on the sound exercise of judgment.

Second, the 5 percent volume ceiling applicable to most members of AFEP is overly restrictive compared to actual shareholder expectations, as seen both in the voting results of French general shareholder meetings and in what the same shareholders find acceptable outside of France. As ISS has acknowledged in its call for comments, the prevailing levels of equity plan volumes are significantly in excess of the level found in ISS’s current policy. Because under French corporate law, equity compensation requires specific shareholder authorisation with a 2/3 majority, we understand this to mean that ISS’s current policy on this point is not in line with the expectations or priorities of a large majority of shareholders who vote. While the listed companies subject to this ISS policy may be French, it is important to note that a large part of their shareholder base is not. Outside of France, dilution levels are generally higher than what French Boards of Directors tend to propose, which is an additional indicator of what most shareholders in French listed companies tend to view as appropriate. In

this connection, we note that ISS's own policies outside of France - e.g., "ISS' 2011 U.S. Proxy Voting Guidelines Summary"- accommodate the possibility of such higher levels of dilution.

We note that the 10 percent volume ceiling proposed would appear to be consistent with the current policy of the AFG (the French Asset-Management Association) and does not conflict with the requirements of the AFEP-MEDEF code of corporate governance which does not impose a specific ceiling but calls for Board restraint.³

Introducing a burn rate criterion to measure use of capital

The principle of a burn rate in lieu of a volume ceiling (or at least in combination with a less restrictive volume ceiling than is currently practiced by ISS) is an attractive option, which echoes the French law requirement that a corporation obtain a shareholder authorization of no more than 38 months allowing the issuance of an agreed maximum amount of dilution. It would also correspond to a certain notion of fairness to issuers and consistency for shareholders, because a burn rate is used by ISS in its U.S. policy. A focus on burn rate would have the additional advantage of not penalizing companies for past grants that remain unexercised (and therefore continue to be counted as potential dilution) because their strike prices are significantly higher than the market price. However, ISS is proposing a lower cap for French issuers than the one ISS has put in place for the United States,⁴ this difference cannot be rationally justified : ISS should consider applying the same burn rate threshold (2%) to French issuers.

While the proposal is very positive, several important questions remain. Based on the rather succinct proposal, it is not clear how such a policy would in fact apply.

If the burn-rate is prospective, how is a three year burn rate to be calculated for companies that request shareholder authorisations of less than the maximum 38 months, or for companies that stagger the authorisations to grant performance shares and the authorisations to grant options?

Is the sector group French, European or Global? How will ISS tackle the problem of sectors in which the group of peers is very limited? Because shareholders are global, and the competition for talent is cross-border, it is our position that the sector should also be measured globally.

Will there be an undisputed source for the average burn rate and the standard deviation for each sector? ISS discloses the burn rate used in the US through the ISS Policy Gateway, and could also make available specific burn rates thresholds dedicated to the French market. If ISS doesn't consider publishing burn rate for each sector, how can issuers possibly be informed of the burn rate that will be applied to them? The timing of ISS's publication is also important. This data should be published sufficiently ahead of the AGM (November/December) so that issuers can take them into account.

³ Le total des plans d'options et d'actions doit représenter une faible part du capital. [§20.2.3]

⁴ "The company's three year burn rate exceeds the greater of 2% or the mean plus one standard deviation of its industry group but no more than two percentage points (+/-) from the prior-year industry group cap"

Definition of “executive director”

ISS intends to define the "executives" as all members of a company's management board⁵ or executive committee, plus any other director classified as an executive under ISS' director election policy. This appears to be an appropriate definition, with one small caveat. While most large French corporations have set up executive committees as a practical management tool, not every French company has one because such a body has no basis in French law. Therefore, even with this definition, some cases will continue to require the exercise of judgement.

Reference to track record rather than specific future engagements

ISS prefers that companies disclose quantified performance targets for future awards. Companies are not always in a position to do so even for objective criteria. For example, where annual budget criteria are used, the relevant amounts are not quantifiable at the point in time that a shareholder authorization is requested. Furthermore, even if such amounts were quantifiable, their publication may cause competitive harm to the company (see above). While the AFEP-MEDEF code of corporate governance requires performance criteria to be challenging, and requires non-qualitative conditions to be quantifiable, there is no express requirement for the external publication of quantified performance targets.

In France, a common practice which has been developed is for issuers to disclose in their annual reports the level of attainment of performance criteria at the end of the performance period. We believe that such disclosure can provide investors with good faith assurances of the seriousness with which the Board takes its responsibility to set demanding performance criteria, and provides shareholders with a calculation which has been reviewed by the companies' external auditors.

⁵ We understand this to refer to a Directoire, for companies organized as a Société anonyme à conseil de surveillance.