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EXEQUITY

Independent Board and Management Advisors

Client Alert

ISS Issues Draft 2012 Policies

On October 18, 2011, Institutional Shareholder Services Inc. (ISS) issued ***draft*** 2012 Policies for comment.[1] Comments can be submitted through ***October 31, 2011***. Admittedly this is a very short comment period, but ISS already solicited comments through its 2011–2012 Policy Survey this summer. The draft policies appear to make an attempt to address some of the concerns raised by corporate issuers in the last proxy season. Consequently, we would not be surprised if ISS adopts as final what is substantially proposed. Note also that these draft policies do not necessarily include all of the policies ISS may be issuing in November as part of its final 2012 Policy changes, only the ones for which ISS is seeking further comment.

In summary, the draft policies address four issues, specifically ISS's:

- Pay for performance (P4P) policy which, as proposed, is a ***major*** shift in the way it will analyze the P4P relationship between company performance and CEO pay for purposes of Say on Pay (SOP) vote recommendations;
- Response if companies do not take satisfactory action to address an SOP vote in the prior year that received "significant" opposition;
- Response if companies do not adopt the frequency that received majority support (or plurality support, if no majority) in last year's Say When on Pay (SWOP) vote; and
- Recommendation with respect to IPO companies that are seeking shareholder approval of plans solely for the purpose of qualifying compensation as performance-based under Section 162(m).

Additional information on the draft policies follows.

[1] These draft policies are available at: http://www.issgovernance.com/policy/2012comment.

Compensation: Evaluation of Executive Pay

ISS is proposing a new methodology for evaluating P4P alignment. ISS will assign an alignment rating, i.e., strong, satisfactory, or weak, presumably on the basis of a quantitative analysis of three factors in two categories, a **relative** and an **absolute** category, each proposed to be weighted 50% but the precise methodology ISS will utilize has not been disclosed. Companies demonstrating a strong or satisfactory alignment will generally receive a positive vote recommendation (in the absence of other pay-related issues). If alignment is deemed weak, the quantitative analysis will be followed by a qualitative analysis.

Relative Quantitative Analysis

The relative analysis is intended to determine the P4P alignment "within a group of companies similar to the company in market cap, revenue (or assets) and industry." The group ISS has used in the past has been based on a company's 4-digit GICS industry group. Presumably, the new group will be more similar to the company because of the additional factors ISS is proposing. The two quantitative analyses are:

- The degree of alignment between the company's TSR rank and the CEO's total pay rank within the peer group as measured over one- and three-year periods (weighted 40%/60%, to put more emphasis on longer-term); and
- The multiple of the CEO's total pay relative to the peer group median, which may identify cases where a high-performing company may nevertheless be overpaying.

Absolute Quantitative Analysis

This category measures long-term alignment between pay and company performance as the alignment between the trend in the CEO's pay and the company's TSR over the prior five fiscal years, i.e., the difference between the slope of annual pay changes and the slope of annualized TSR changes during the five-year period.

Qualitative Analysis

If the quantitative analysis above results in an alignment that is deemed weak, the qualitative review will consider:

- The ratio of performance- to time-based equity awards;
- The overall ratio of performance-based compensation;
- The robustness of disclosure and rigor of performance goals;
- The company's peer group benchmarking practices;
- Actual results of financial/operational metrics, such as growth in revenue, profit, cash flow, etc., both absolute and relative to peers;
- Special circumstances related to, for example, new CEO in prior fiscal year or equity grant practices (e.g., biannual awards); and
- Any other factors deemed relevant.

Request for Further Comment

ISS is seeking comment on the following:

- Do the factors utilized in ISS's proposed P4P evaluation approach align with those that your organization believes should be considered?
- Does the proposed new approach give adequate consideration to long-term alignment?
- Will the proposed new approach be beneficial to your organization in identifying companies with strong P4P alignment?
- What additional factors, if any, should ISS consider and display to improve investors' ability to evaluate companies' long-term pay-performance alignment?

Exequity Comment: *As we indicate above, this proposed policy represents a major change from ISS's current P4P analysis. On the positive side, it is attempting to place more emphasis on the longer-term, and is deemphasizing relative performance by placing greater weight on a company's absolute P4P alignment.*

However, one key issue will be the companies that ISS includes in a company's peer group. If ISS continues to utilize as simplistic a methodology as it has in the past in developing peer groups (e.g., taking the first 12 companies based on revenues within the same GICS code closest to the subject company), it likely will create problems in the relative comparison portion of the analysis for many companies. More importantly ISS has shown no signs of revisiting how it measures pay for these purposes. To this point, the ISS analysis has essentially included the value of equity awards as of the date of grant, rather than the value that executives actually realize from the grant. As a result, ISS's pay analysis includes grants that will not be realized if performance is inadequate—in other words, their measure of pay misses the whole point of correlating pay and performance. In addition, the option valuation methodology, which was widely criticized, is not addressed.

Board Response to Management SOP Votes

ISS will consider prior SOP proposals that received "significant" opposition when recommending on Compensation Committee members, as well as the current SOP vote, taking into account:

- The level of opposition;
- The company's ownership structure;
- Disclosure of engagement efforts with major institutional investors regarding compensation issue(s);
- The company's response;
- Specific actions taken to address the issue(s) that appear to have caused the significant level of against votes;
- Other recent compensation actions taken by the company; and
- ISS's current analysis of the company's executive compensation and whether any prior issues of concern are recurring or one-time.

ISS's draft policy did not specify what level of opposition would warrant this approach. However, ISS's draft policy did state that a higher level of scrutiny would be applied for companies where SOP received less than 50% support. Further, recurrence of previously identified compensation issues or newly identified compensation concerns, depending on the severity, may result in an **against** vote on SOP and the Compensation Committee members.

Request for Further Comment

ISS is seeking comment on the following:

- Does a support level of less than 70% warrant an explicit response from a company to address concerns, i.e., including actions or an action plan? If not, what opposition level warrants an explicit response?

- Should boards be expected to provide an explicit response to a low-supported SOP proposal by the year following that vote, or should accountability be based on the results of more than one low SOP vote?

- Are there additional factors that investors should consider for the case-by-case analysis, besides those mentioned above?

Exequity Comment: *ISS appears to be looking at support of 70% of votes cast in favor of the SOP as the cut-off for determining whether a company must address the "low" level of support it received for its SOP vote. But note that the 70% figure only appears in the questions ISS posed, not within the draft policy itself. This would be less burdensome than the 80% that the ISS 2011–2012 Policy Survey Results indicated received the highest level of support for requiring an explicit response from the board regarding improvements to pay practices. ISS may consider adopting a 2-strike policy like it did with shareholder proposals that received majority support—if a company ignored such proposals after they received support for two years in a row, ISS would consider that in fashioning its vote recommendation for Compensation Committee members, or possibly all directors.*

Board Response to Management SWOP Votes

ISS is proposing a new vote recommendation policy for SWOP:

- Vote **withhold/against** on **all incumbent director nominees** if the board implements an advisory vote on a less frequent basis than the frequency which received a majority of the votes cast at the most recent meeting.

- Vote **case-by-case** if the board implements a frequency that is different than the frequency that received a plurality, but not majority, of votes cast at the most recent meeting, taking into account:

  — The board's rationale for doing so;

  — The company's ownership structure;

  — ISS's analysis of the company's executive compensation and whether there are compensation concerns or a history of problematic pay practices;

  — The previous year's support level on the company's SOP proposal; and

  — The difference between the frequency adopted and the frequency supported by shareholders.

Request for Further Comment

ISS is seeking comment on the following:

- In cases where a company fails to adopt an SOP frequency that received majority support by shareholders, should there be additional considerations given to these companies?

- In cases where a company implements an option that is less frequent than that which received a plurality, but not a majority, of votes cast (e.g., one year received 43% of votes cast, two year received 1%, and three year received 39%, excluding abstentions), would the proposed factors help your organization analyze such situations? Are there other factors that your organization would recommend?

Exequity Comment: *As one might have expected, ISS will try and penalize companies that adopt an advisory vote on a less frequent basis than the vote frequency voted for by a majority of shareholders (if one exists) or by a plurality of the vote in other cases. We expect if a company adopts a less frequent vote than that supported by a majority or plurality of the votes, it will have a tough time (and likely impossible, if a frequency received majority support) convincing ISS that the decision was in the best interests of the company. As a result, we expect ISS to generally recommend* ***against*** *directors at companies that adopt a less frequent vote than the frequency supported by the majority or plurality of the vote.*

Compensation: Equity Plans Related to Section 162(m)

ISS is proposing that it would conduct a full analysis of an IPO equity plan put to shareholders for 162(m) qualification purposes, regardless of whether the plan was approved prior to the company going public. Previously, ISS has generally recommended a vote "**for**" such plans without conducting a full analysis of the plan (e.g., costing of the plan and burn rate analysis).

Request for Further Comment

ISS is seeking comment on the following:

- Should the potential tax deduction on performance-based compensation for named executive officers outweigh the adverse impact of problematic features in equity plans for 162(m) proposals from new IPO companies?

- If shareholders do not support the 162(m) proposal at the newly public company, the company would not be able to obtain a tax deduction for performance-based compensation. Should the Compensation Committee be held accountable for the problematic design in the equity plan instead?

Exequity Comment: *This approach will add a much higher level of scrutiny to the equity plans of new IPO companies and more quickly expose those companies to ISS's influence in the compensation space.*

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