CAPflash
CAP Compensation Advisory Partners NEWSLETTER | ISSUE #40 | NOVEMBER 20, 2012

ISS 2013 Policy Updates

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On November 16th, Institutional Shareholder Services (ISS) released its final 2013 policy updates which were largely consistent with the proposal issued in October. The policy changes apply to shareholder meetings on or after February 1, 2013 and cover several areas that impact executive compensation.

- Evaluation of Executive Pay (Management Say on Pay)
  - I. Incorporate a company's selected peers as an input to its peer group selection methodology, while maintaining an approach that includes company size and market capitalization constraints
  - II. Potentially incorporate a comparison of realized pay to grant date pay as part of the qualitative evaluation of pay-for-performance alignment
- Voting on Golden Parachutes in an Acquisition, Merger, Consolidation, or Proposed Sale
  - I. Include existing change in control arrangements maintained with named executive officers rather than focusing only on new or extended agreements
  - II. Place further scrutiny on multiple legacy problematic features in change in control agreements
- Pledging
  - I. Identify significant pledging as a failure of risk oversight with a negative vote recommendation directed against the board of directors

Below CAP summarizes the key policy changes and we also provide perspective on the key implications for companies to consider.

CURRENT PEER GROUP SELECTION PROCESS FOR PAY-FOR-PERFORMANCE EVALUATION

For 2012, ISS selected the subject company's peer group using market cap and revenue (or assets for financial firms) and the subject company's GICS industry group. The peer group is generally comprised of 14-24 companies that are closest to the subject company, and where the subject company is close to median of the peer group in revenue/asset size.

The policy changes apply to shareholder meetings on or after February 1, 2013 and cover several areas that impact executive compensation.

UPDATED PEER GROUP SELECTION PROCESS FOR PAY-FOR-PERFORMANCE EVALUATION

For 2013, ISS revised the peer group selection process to include companies in GICS industry groups represented in the subject company's self-selected peer group. The size parameters used in the selection process continue to include market cap and revenue, though assets will be used for certain financial firms. ISS will consider the subject company's GICS industry group as well as the GICS industry group(s) of companies within the subject company's self-selected peer group. The peer group continues to generally include 14-24 companies and is designed to emphasize peers that are closest to the subject company in terms of revenue/asset size and industry, are in the subject company's peer group and have chosen the subject

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company as a peer. Selected peer companies will also remain within the company's market cap bucket.

ISS will also use slightly relaxed size constraints, especially at very small and very large companies. For certain financial firms, revenues will be used instead of assets for screening.

ISS Intent and Impact

The new approach incorporates the subject company's GICS industry group as well as additional GICS industry group(s) represented in the company's self-selected pay benchmarking peer group. This change was intended to identify and prioritize GICS industry groups beyond the subject company's GICS industry. Backtesting of the new vs. old methodology indicates that this change will result in a greater degree of overlap between the ISS peer group and the subject company's self-selected peer group. This revision will not impact the size comparison of the subject company relative to the selected peer group since size revenue/asset and market cap size constraints will be maintained.

CAP Perspective: *ISS' peer group revisions address the criticism that the current "one size fits all" approach to the peer group selection process does not accurately take into account a company's business model and company-specific considerations. Without taking into consideration the company's self-selected (and Board approved) peer group, ISS' current process has limitations and lacks credibility.*

The revised approach provides greater alignment between ISS' peer group and the company's self-selected peer group. We expect companies and Compensation Committee to find the revised peer groups to be more credible due to the stronger emphasis on the relevance of the company's business model. In addition, the revised peer groups are more likely to take into account the companies used for compensation benchmarking purposes.

CURRENT PAY-FOR-PERFORMANCE EVALUATION

The approach for 2012 included quantitative and qualitative components. The quantitative analysis reviews three factors for companies in the Russell 3000 index:

Relative Peer Group Alignment –

1. 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-year and three-year periods (weighted 40/60, to put more emphasis on the longer term)

2. The multiple of the CEO's total pay relative to the peer group median

Absolute Alignment – this factor measures long-term alignment between pay and company performance, as:

3. 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 trend in annual pay changes and the trend in annualized TSR changes during the prior 5-year period

If ISS determines that these analyses demonstrate a weak alignment between pay and performance, ISS will conduct a qualitative review before issuing a final vote recommendation.

Considerations for the **qualitative review** include:

- The ratio of performance- to time-based equity awards
- The ratio of performance-based compensation to overall compensation
- The completeness 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, a new CEO in the prior FY or anomalous equity grant practices (e.g., biannual awards)
- Any other factors deemed relevant

UPDATED PAY-FOR-PERFORMANCE EVALUATION

The pay-for-performance evaluation for 2013 continues to include a quantitative and qualitative component. The three quantitative tests remain unchanged from 2012 although the tests will be performed using the revised peer group described above.

ISS will continue to conduct a qualitative review for companies that demonstrate a weak alignment between pay and performance. The considerations incorporated in the qualitative review for 2013 remain the same as 2012 with the addition of a comparison of realizable pay to grant pay for large cap companies.

Realizable pay will consist of relevant cash and equity-based grants and awards made during a specified period being measured. Equity award values are based on actual earned awards, or target values for ongoing awards, calculated using a stock price at the end of the performance measurement period. Stock options or stock appreciation rights (SARs) will be re-evaluated using the remaining term and updated assumptions, using a Black-Scholes option pricing model.

ISS Intent and Impact

ISS' revision to potentially incorporate a comparison of realizable pay to grant date pay as part of the qualitative evaluation, when necessary, for large cap companies provides an additional perspective for assessing the pay-for-performance alignment between CEO compensation and company performance. This new factor may either increase or reduce the pay-for-performance concerns identified through the quantitative component of the pay for performance review. Large cap companies will likely be defined as the S&P 500 or a similar group.

CAP Perspective: *ISS' inclusion of realizable pay provides a critical perspective on CEO compensation. If the CEO's compensation creates a pay-for-performance misalignment, it is important to understand the total value the CEO may be able to realize over a specific performance period or at a given time. We believe this assessment will provide additional context for CEO compensation decisions.*

ISS' final 2013 policy summary is silent on whether the realizable pay will be compared to the ISS peer group or company's financial performance. An ISS representative indicated that realizable pay will be compared to grant date pay, but not to peer companies. In isolation from financial performance or a relative peer analysis, assessing the CEO's realizable pay vs. actual compensation has its limitations and does not provide sufficient context for the company'sspecific situation.

One problem with ISS' definition of realizable pay is that outstanding stock options will be valued using a Black-Scholes model rather than intrinsic value. As a result, a portion of the so-called realizable pay may never be realized, if options are underwater.

VOTING ON GOLDEN PARACHUTES IN AN ACQUISITION, MERGER, CONSOLIDATION, OR PROPOSED SALE

Current Recommendation

ISS will vote on a **case-by-case** basis on proposals to approve the company's golden parachute compensation, consistent with policies on problematic pay practices related to severance packages. Features that may lead to a vote **against** include:

- Recently adopted or materially amended agreements that include excise tax gross-up provisions (since prior annual meeting);
- Recently adopted or materially amended agreements that include modified single triggers (since prior annual meeting);
- Single trigger payments that will happen immediately upon a change in control, including cash payment and such items as the acceleration of performance-based equity despite the failure to achieve performance measures;
- Single-trigger vesting of equity based on a definition of change in control that requires only shareholder approval of the transaction (rather than consummation);
- Potentially excessive severance payments;
- Recent amendments or other changes that may make packages so attractive as to influence merger agreements that may not be in the best interests of shareholders;
- In the case of a substantial gross-up from pre-existing/grandfathered contract: the element that triggered the gross-up (i.e., option mega-grants at low point in stock price, unusual or outsized payments in cash or equity made or negotiated prior to the merger); or
- The company's assertion that a proposed transaction is conditioned on shareholder approval of the golden parachute advisory vote. ISS would view this as problematic from a corporate governance perspective.

An ISS representative indicated that realizable pay will be compared to grant date pay, but not to peer companies.

New Recommendation

For 2013, ISS revised the features that may lead to a vote against the company's golden parachute compensation to include consideration of existing change in control arrangements maintained with named executive officers, rather than focusing only on new or extended arrangement.

ISS will scrutinize multiple legacy problematic features in change in control agreements and may recommend **against** the proposal if agreements include one or more of the following, depending on the number, magnitude, and/or timing of issue(s):

- Single- or modified-single-trigger cash severance;
- Single-trigger acceleration of unvested equity awards;
- Excessive cash severance (>3x base salary and bonus);
- Excise tax gross-ups triggered and payable (as opposed to a provision to provide excise tax gross-ups);
- Excessive golden parachute payments (on an absolute basis or as a percentage of transaction equity value); or
- Recent amendments that incorporate any problematic features (such as those above) or recent actions (such as extraordinary equity grants) that may make packages so attractive as to influence merger agreements that may not be in the best interests of shareholders; or
- The company's assertion that a proposed transaction is conditioned on shareholder approval of the golden parachute advisory vote.

Recently adopted or materially amended agreements that include problematic practices will tend to carry more weight on the overall analysis. However, ISS will closely scrutinize the presence of multiple legacy problematic features.

ISS Intent and Impact

ISS' revised voting recommendations puts additional pressure on boards of directors and companies to revisit existing contractual obligations. Clearly companies are not able to simply walk away from their obligations, but there may be me greater appetite to renegotiate this arrangement.

The biggest change to the list of problematic practices is the addition of single-trigger acceleration of unvested equity awards. This practice is widespread, even though a number of companies have moved to double trigger vesting.

We look forward to understanding how ISS will define an "excessive" golden parachute going forward.

CAP Perspective: *ISS' revised policies place increasing pressure on companies to make changes to existing contracts with problematic features. ISS' stringent point of view on single-trigger acceleration of unvested equity awards will likely have an impact on contracts with this provision over time. The pressure to eliminate certain problematic provisions will be stronger for companies that are moving towards a corporate transaction.*

PLEDGING

ISS' proposed draft policy on the practice of pledging company stock as a problematic pay practice under ISS' say-on-pay evaluation was viewed negatively by issuers. ISS indicated that discussions with investors led it to conclude that significant pledging is problematic and represents a failure of risk oversight. ISS concluded that the potential negative vote recommendation should be directed towards the election of directors rather than to a company's say-on-pay proposal.

ISS' revised policies place increasing pressure on companies to make changes to existing contracts with problematic features.

For 2013, ISS will view pledging on a **case-by-case** basis to determine whether the pledging rises to a level of serious concern for shareholders. ISS is viewing significant pledging as a failure of risk oversight whereby directors should be held accountable (rather than communicating concern through a say-on-pay recommendation). To determine the vote recommendation for directors, at companies with pledging policies, the following should be considered:

- Presence in the company's proxy statement of an antipledging policy that prohibits future pledging activity;
- Magnitude of aggregate pledged shares in terms of total common shares outstanding or market value or trading volume;
- Disclosure of progress or lack thereof in reducing the magnitude of aggregate pledged shares over time;
- Disclosure in the proxy statement that stock ownership and holding requirements do not include pledged company stock; and
- Any other relevant factors.

ISS also indicated that any hedging will result in a negative voting recommendation on the election of directors. Hedging includes a variety of strategies used to reduce or eliminate the impact of stock price declines, including puts, covered calls, collars or other derivative transactions.

ISS Intent and Impact

ISS 2013 policy on pledging places pressure on companies to monitor and unwind situations where pledging rises to a level of serious concern for shareholders. ISS is silent on the definition of "significant" pledging, however, ISS indicates that significant pledging may have an impact on the vote recommendations for the election of directors.

CAP Perspective: *Pledging provides flexibility by allowing executives access to lower cost financing without having to sell company stock to fund other purposes. It is important to provide balance between this greater flexibility and monitoring of excessive leverage. Excessive leverage is never a good thing and to the extent that executives do pledge shares certain safeguards should be in place.*

Pledging causes concern for investors if the stock price could be impacted by an executive's sale of the shares. In addition, issues may arise if a margin call forces a sale, particularly during a period where the trading window is closed. These concerns could be prevented by requiring the executive to attest that other liquid assets, unrelated to company stock, are readily available to satisfy any potential margin call. Stock ownership guidelines help to mitigate the compensation risk associated with pledging since it ensures that the executive remains invested in the company stock, even while pledging a portion of shares owned.

Many concerns with pledging could be prevented by requiring the executive to attest that other liquid assets, unrelated to company stock, are readily available to satisfy any potential margin call.

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Please contact us at (212) 921-9350 if you have any questions about the issues discussed above or would like to discuss your own executive compensation issues. You can access our website at www.capartners.com for more information on executive compensation.