CAPflash

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ISS 2012 Proposed Policy Changes

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On October 18th, Institutional Shareholder Services (ISS) announced that it was opening its comment period (deadline is October 31st) for proposed 2012 policy changes. It is considering making proposals in several areas that may have an impact on executive compensation.

- Evaluation of Executive Pay (Management Say on Pay)
- Board Response to the Management Say on Pay (MSOP) vote and the MSOP Frequency vote
- Developing a voting policy for recent IPO companies 162(m) approvals

Below CAP summarizes the key policy changes contemplated by ISS, along with areas where they are seeking comment. We also provide perspective on the key implications for companies to consider.

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Evaluation of Executive Pay

Current Pay-for-Performance Analysis Approach

Companies with one- and three-year total shareholder returns (TSR) below the median of their 4-digit GICS industry group are reviewed by ISS for potential pay-for-performance disconnects. For these companies, ISS conducts a qualitative assessment to determine if pay and performance are misaligned. The factors reviewed include year-over-year change in CEO pay and trends in CEO pay and company TSR over 5 years.

Proposed Pay-for-Performance Analysis Approach

The proposed approach for 2012 continues to have quantitative and qualitative components. The quantitative analysis would review three factors in two categories:

1. ***Relative Alignment*** – Two factors are analyzed to determine the pay-for-performance alignment within a group of companies similar to the company in market cap, revenue (or assets), and industry. The peer group is generally comprised of 14-24 companies that are selected on the basis of size and GICS industry group, via a process designed to select peers that are closest to the subject company in terms of revenue/assets (for financial firms) and industry and also within a market cap range that is reflective of the company's life cycle maturity phase

   a. 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)

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  b. The multiple of the CEO's total pay relative to the peer group median, which may identify cases where a high performing company may be overpaying

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

   - Alignment between the trend in the CEO's pay and the company's TSRs 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 prior 5-year period

For the quantitative assessment, the relative and absolute test may be weighted 50/50. ISS will generally provide a positive recommendation (absent other pay related issues) to companies demonstrating strong or satisfactory alignment. If the alignment is weak, 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 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, a new CEO in the prior FY or equity grant practices (e.g., biannual awards)
- Any other factors deemed relevant

ISS Intent and Impact

The proposed approach continues to use multiple factors with a stronger emphasis on long-term alignment, while maintaining in-depth qualitative analysis. ISS does not anticipate that the change in methodology will result in a significant change in the number or percentage of negative recommendations issued. Backtesting by ISS of the new methodology indicates a strong correlation between the results and shareholder say-on-pay votes in 2011. ISS is requesting comments on the factors they are using, whether the new approach appropriately emphasizes the long-term and if there are other factors they should be considering.

CAP Perspective: *ISS's proposed changes appear to address criticism that their current approach is a one size fits all approach and does not take into consideration company specific circumstances. This is evidenced in several areas:*

- *the modification of peer group to take into account factors in addition to industry such as size and life cycle*
- *inclusion of absolute alignment gives weight to a company's own pay and TSR trends*
- *more robust list of qualitative factors that consider operational results in addition to TSR as well as company specific practices*

We expect companies and Compensation Committees to continue their focus on aligning their compensation programs with performance as we head into the second full year of Say on Pay.

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Board Response to the MSOP and MSOP Frequency Votes

Following the first year of Say-on-Pay, ISS has conducted research with investors indicating a high degree of interest in having boards and Compensation Committees provide an explicit response to MSOP proposals that receive less than a majority support or weak majority support.

ISS' proposed policy update states that they will recommend **case-by-case** on Compensation Committee members (or in rare cases where the full board is deemed responsible, all directors) and the current MSOP proposal if the company's prior year say-on-pay proposal received significant opposition from votes cast, taking into account multiple factors, including:

- The level of opposition
- The company's ownership structure
- Disclosure of engagement efforts with major institutional investors regarding the 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
- ISS' current analysis of the company's executive compensation and whether any prior issues of concern are recurring or one-time

ISS will place more scrutiny on companies where an MSOP proposal received less than 50 percent support from all votes cast or where there are previously identified compensation issues or newly identified compensation concerns. Depending on the severity of the concerns, it may result in an **against** vote recommendation on Management Say on Pay and the Compensation Committee members. ISS is seeking comment on this policy to determine what the threshold (e.g., <70% support) should be for requiring an action plan from companies on how they will address shareholder concerns with their compensation plans and whether ISS should require more than one year of a low vote before expecting a response to shareholder concerns from boards.

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In terms of the MSOP Frequency, ISS' proposed policy is more straightforward. ISS will recommend a **withhold/against** vote on all incumbent director nominees if the company implements an advisory vote on executive compensation on a less frequent basis than what the majority of voters supported. ISS will address votes on a **case-by-case** basis on all incumbent director nominees if the company implements an advisory vote on executive compensation on a less frequent basis than what the majority of voters supported. Factors entering into ISS' decision will include the board's rationale for choosing the frequency, the company's ownership structure, ISS analysis of the company's executive compensation plans, the previous year's level of support for the MSOP and the difference between the frequency adopted and the frequency supported by shareholders. ISS is asking for comments on whether there should be any additional factors considered in cases where a company adopts a say-on-pay frequency different from that preferred by the majority of shareholders and in plurality cases whether the factors identified are helpful and if there are other factors that would be of more use in assessing the decision to deviate from the frequency preference of the plurality of shareholders.

CAP Perspective: *ISS has developed these two new policies to develop an enforcement mechanism to ensure that boards are responsive to shareholder votes on these non-binding measures. By potentially recommending a withhold/against vote on a director if the company is not adequately responsive to shareholders on MSOP or MSOP frequency, ISS is trying to ensure that these votes have "teeth" and directors are held accountable.*

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Equity Plans Related to 162(m)

Under a proposed ruling related to IRC Section 162(m), recent IPO companies will now have to obtain shareholder approval before awarding certain performance-based restricted stock units ("RSUs") to named executive officers in order to qualify them as performance-based compensation. While ISS has generally recommended that investors support equity plans solely for 162(m) purposes, they felt a new policy was warranted to establish a new policy to address these IPO companies.

ISS will vote on a **case-by-case** basis on these plans and will subject them to a full equity plan analysis, including a review of total shareholder value transfer, repricing, burn rate analysis and liberal change in control. If the plans are not asking for additional shares, ISS still anticipates supporting the vast majority of plans.

> ***CAP Perspective:*** *This provision is unlikely to have major impact, but is something that companies moving toward an IPO should incorporate into their planning. To increase the likelihood of ISS support, pre-IPO companies should ensure that their equity plans overall have shareholder friendly provisions and that the share reserve is not excessive.*

We expect the pay-for-performance policy to be the area of greatest focus as companies enter the 2012 proxy season and try to understand how ISS will be evaluating their compensation programs.

Conclusion

We expect the pay-for-performance policy to be the area of greatest focus as companies enter the 2012 proxy season and try to understand how ISS will be evaluating their compensation programs. While ISS' proposed approach appears to be an attempt to recognize issues with their current pay-for-performance test, there will still likely continue to be a disconnect between how ISS views a company's performance and the company's own internal view of performance. In addition, the new pay-for-performance disclosure under Dodd-Frank may vary from ISS' proposed approach and create additional confusion around what is the appropriate way to assess pay-for-performance. In any case, ISS and other shareholders will be looking for a clear demonstration that positive action is taken where there is a major shareholder concern about the executive compensation program.

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.