CAPflash
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# ISS 2012 Policy Updates

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On November 17th, Institutional Shareholder Services (ISS) released its final 2012 policy updates which were largely consistent with the proposed updates issued in October. The policy changes apply to shareholder meetings on or after February 1, 2012 and cover several areas that impact 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 and we also provide perspective on the key implications for companies to consider.

## 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.

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*Updated Pay-for-Performance Evaluation*

The approach for 2012 continues to have quantitative and qualitative components. The quantitative analysis reviews three factors in two categories (for companies in the Russell 3000 index):

1. ***Peer Group Alignment*** – Two factors are analyzed to determine the pay-for-performance alignment relative to a peer group that is generally comprised of 14-24 companies selected using market cap, revenue (or assets for financial firms), and GICS industry group. The selection process is designed to identify peers that are closest to the subject company, and where the subject company is close to median of the peer group in revenue/asset size. ISS will disclose its peer group methodology and rationale in various communications leading up to the 2012 proxy season.

   b. 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)

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

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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 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

There is no explicit description of the relative importance of the peer group alignment and absolute alignment in ISS' evaluation. If ISS' analysis finds that the above analysis demonstrates 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

It should be noted that except in extenuating circumstances, ISS indicates that there is no longer a "new" CEO exclusion from the pay-for-performance evaluation.

In the spirit of transparency, ISS will provide additional guidance on the 2012 Pay-for Performance methodology in a technical document that is scheduled for release in December.

## ISS Intent and Impact

The new 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.

***CAP Perspective:*** *ISS' 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 similarity and size*
- *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. The elimination of the exclusion for "new" CEOs may create a challenge for any companies that have had to pay significantly to recruit a CEO and will likely be viewed as controversial as the new CEO will have had limited ability to impact performance.*

## Board Response to the MSOP and MSOP Frequency Votes

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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' 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 less than 70% of votes cast, taking into account:

- The company's response, including:
  - Disclosure of engagement efforts with major institutional investors regarding the compensation issue(s)
  - 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
- Whether the issues raised are recurring or isolated
- The company's ownership structure
- Whether the support was less than 50 percent, which would warrant the highest degree of responsiveness

In terms of the MSOP Frequency, ISS' 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 the frequency preferred by a plurality (but not a majority) of voters. Factors entering into ISS' decision will include the board's rationale for choosing the frequency, the company's ownership structure and vote results, ISS analysis of the company's executive compensation plans and the previous year's level of support for the MSOP.

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***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. Where companies received a less than 70% approval vote on the MSOP, "substantive and meaningful" disclosure of key steps taken to address potential shareholder concerns about the compensation program will be essential to getting ISS support in the following year.*

## 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 address these IPO companies.

ISS will generally vote **for** proposals to approve or amend executive incentive bonus plans if the proposal:

- Is only to include administrative features
- Places a cap on the grants any one participant may receive to comply with the provisions of Section 162(m)

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- Adds performance goals to existing compensation plans to comply with the provisions of Section 162(m) unless they are clearly inappropriate
- Covers cash or cash and stock bonus plans that are submitted to shareholders for the purpose of exempting compensation from taxes under the provisions of Section 162(m) if no increase in shares is requested

ISS will generally vote **against** proposals if:

- The compensation committee does not fully consist of independent outside directors, per ISS' director classification
- The plan contains excessive problematic provisions

ISS will vote on a **case-by-case** basis on proposals if:

- In addition to seeking 162(m) tax treatment, the amendment may result in the transfer of additional value to employees (e.g., by asking for additional shares, extending option term, etc.); it will be subject a Shareholder Value Transfer analysis vs. the allowable cap
- A company is presenting the plan to shareholders for the first time after the company's initial public offering (IPO). A full equity analysis will be conducted, including a review of total shareholder value transfer, repricing, burn rate analysis and liberal change in control. Other factors such as pay-for-performance or problematic pay practices as related to MSOP may also be included in ISS' recommendation

***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.*

## 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' new approach appears to be an attempt to recognize issues with their current pay-for-performance test, there will likely continue to be a difference between how ISS views a company's performance and the company's own internal view of performance. ISS' move towards increased transparency may assist companies in replicating their pay for-performance analysis. This may provide a better understanding of how ISS is likely to view their compensation programs. Companies with concerns about the shareholder vote on MSOP and ISS' potential recommendations may find it worthwhile to model out the ISS analysis on their own, though the exercise will likely require significant resources and expense.

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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.