RADFORD ALERT: 2012 ISS Corporate Governance Policy Updates

An Overview of Key ISS Policy Changes for US-Based Companies Ahead of Proxy Season

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In late November, Institutional Shareholder Services (ISS) released its final set of corporate governance policies for 2012. As might be expected, the latest round of policy updates focused on fine-tuning CEO pay-for-performance tests, an area where ISS received significant pressure to refine its methodologies, and incorporating say-on-pay results into future voting recommendations. To assist clients in understanding these updates, the following Radford Alert summarizes four key areas of policy changes. In the coming months, as ISS releases further guidance on voting and burn rate guidelines, Radford will follow-up with additional alerts.

Peer Groups Take Center Stage in Revised CEO Pay for Performance Tests

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In light of client, investor and issuer feedback, ISS recently updated its approach to assessing the connection between CEO pay and performance. With respect to companies in the Russell 3000 index, the new methodology will examine CEO pay along two quantitative fronts: peer group alignment and absolute alignment. This will be followed by a series of qualitative assessments if needed. Notably, the peer group alignment portion of the analysis will be conducted against a specific list of 14 to 24 peers, rather than a broad industry group as was the case in past years. Peers will be selected among companies with similar market capitalizations, revenues (or assets for financial services firms) and industry codes (based on the GICS system).

The peer group alignment analysis will examine two issues: (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); and (2) the multiple of the CEO's total pay relative to the peer group median. Meanwhile, the absolute alignment test "will examine the trend in CEO pay and company TSR over the prior five fiscal years – i.e., the difference between the trend in annual pay changes and the trend in annualized TSR during the period."

Ultimately, companies deemed to have an unsatisfactory CEO pay-for-performance alignment will be subject to a qualitative review of their compensation policies and practices. A typical review might include an assessment of the following factors:

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- Ratio of performance to time-based equity awards
- Overall ratio of performance-based compensation
- Robustness of disclosure and rigor of performance goals
- A company's peer group benchmarking practices
- Actual results of financial/operational metrics
- Special circumstances (i.e., a new CEO or equity grant practices)
- Any other factors deemed relevant

Results in these areas will then drive ISS recommendations for 2012 say-on-pay votes.

Compensation Committee Elections in the Era of Say-on-Pay

With the first year of widespread say-on-pay votes completed, ISS will now begin to consider say-on-pay performance when making recommendations on the election of Compensation Committee members (and in rare cases, the full Board, including the CEO). Understandably, companies with failed say-on-pay votes will receive the greatest degree of scrutiny, and face raised expectations for adjusting compensation policies and practices in light of shareholder concerns. Yet, even in the case of failed say-on-pay votes, ISS will make recommendations for director elections on a CASE-BY-CASE basis, and there will not be an automatic trigger to vote against Compensation Committee members based solely on say-on-pay results.

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However, given the relatively low number of failed votes (less than 1.5% of Russell 3000 technology and life sciences sector companies), ISS will also place increased scrutiny on companies with "poor" say-on-pay results, now defined as receiving less than 70% shareholder support for the most recent say-on-pay proposal. In the words of ISS, "investors appeared to be in agreement that less than 70% shareholder support on management say-on-pay proposals is a reasonable trigger for boards to take explicit action with respect to compensation practices." Effectively, this raises the bar for say-on-pay passage from 50% to 70%, and forces companies to devote significant attention to the discussion, mandated by Dodd-Frank, of how and to what extent the company has considered the most recent say-on-pay vote in making compensation decisions.

Overall, while poor performance on say-on-pay proposals will not trigger an AGAINST/ WITHHOLD recommendation for Compensation Committee members in-of-itself, an inadequate written response and set of follow-up actions by the Board to address shareholder concerns will very likely lead to a negative ISS recommendation. Again, in the words of ISS, "for companies that failed to receive meaningful support for their say-on-pay proposals, shareholders will look for substantive disclosures regarding the company's response. In such cases, companies should discuss company outreach efforts to major institutional investors and […] outline the specific actions they have taken to address compensation issues that resulted in significant opposition votes."

ISS Aims for Alignment with Shareholders on Say-on-Pay Frequency

With respect to say-on-pay voting frequency, ISS' new policy is quite direct: companies should align themselves with shareholder wishes. ISS will publish an AGAINST/ WITHHOLD recommendation for all board members (except new nominees, who should be considered on a CASE-BY-CASE basis) if the Board implements an advisory vote on executive compensation on a less frequent basis then the frequency receiving a majority of votes cast at the most recent shareholder meeting where shareholders voted on say-on-pay frequency. In light of this policy, and given the fact that annual vote frequencies received shareholder support at more than 80% of Russell 3000 companies, we can expect the vast majority of companies to hold say-on-pay proposals every year for the foreseeable future.

With respect to companies where no say-on-pay frequency received a majority of votes, ISS has adopted a more nuanced policy. ISS will issue vote recommendations on a CASE-BY-CASE basis for the entire board where the board implements an advisory vote on executive compensation on a less frequent basis than the frequency that received a plurality, but not a majority, of the votes cast at the most recent shareholder meeting at which shareholders voted on the say-on-pay frequency. ISS will take into account the following factors in making its vote recommendation under this policy: (i) The board's rationale for selecting a frequency that is different from the frequency that received a plurality; (ii) The company's ownership structure and vote results; (iii) ISS' analysis of whether there are compensation concerns or a history of problematic compensation practices; and (iv) The previous year's support level on the company's say-on-pay proposal.

Recently Public Companies Face Increased Scrutiny on Equity Plans

In a break from past policy, ISS will now use the initial 162(m) compliance process for newly public companies (generally required four years after an IPO) as a means to assess equity compensation plans in their entirety. As a result, newly public companies will face pressure to adopt ISS supported practices sooner than previously expected. For example, “evergreen” provisions embedded in equity plans pre-IPO may serve as a flashpoint for ISS to recommend AGAINST the qualification of a plan as 162(m) compliant, even if the evergreen provision is unrelated to 162(m) qualification. Effectively, this means the grace period for equity compensation plans approved pre-IPO will shrink to no more than four years. Although failure to achieve 162(m) qualification could adversely affect companies from a tax perspective, ISS believes certain equity plan provisions could prove to be even more “detrimental to shareholders”.

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Going forward, ISS will recommend FOR proposals to approve or amend executive incentive bonus plans if the proposal: (1) Is only to include administrative features; (2) Places a cap on the annual grants any one participant may receive to comply with the provisions of Section 162(m); (3) Adds performance goals to existing compensation plans to comply with the provisions of Section 162(m) unless they are clearly inappropriate; or (4) 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 recommend AGAINST proposals if: (1) The compensation committee does not fully consist of independent outsiders, per ISS' director classification; or (2) The plan contains excessive problematic provisions.

ISS will evaluate proposals on a CASE-BY-CASE basis if: (1) In addition to seeking 162(m) tax treatment, the amendment may cause the transfer of additional shareholder value to employees (e.g., by requesting additional shares, extending the option term, or expanding the pool of plan participants). Evaluate the Shareholder Value Transfer in comparison with the company's allowable cap; or (2) A company is presenting the plan to shareholders for Section 162(m) favorable tax treatment for the first time after the company's initial public offering (IPO). Perform a full equity plan analysis, including consideration of total shareholder value transfer, burn rate (if applicable), repricing, and liberal change in control. Other factors such as pay-for-performance or problematic pay practices as related to Management Say-on-Pay may be considered if appropriate.

Next Steps

To learn more about these policy changes, please contact Radford’s consulting group or visit the ISS website at: http://www.issgovernance.com/policy/2012/policy_information. For information on IPO-related compensation issues, visit www.PreIPOPay.com.

More Information

We encourage you to forward this Alert to your board members. And as always, we encourage you to contact us if you have questions. For more information, contact:

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