RADFORD ALERT

Early Reactions to Say on Pay Recommendations from ISS

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Shareholder Meeting Season Ramps Up

Although the bulk of 2011 say on pay proposals remain to be voted on, it isn't too early to alert clients to emerging trends and potential pitfalls. As of the first week in May, 13 say on pay proposals have already failed to gain a majority of shareholder support, and it is clear from our analysis that Institutional Shareholder Services ("ISS") recommendations are making an impact. When ISS provides a negative recommendation, average support for say on pay proposals drops from 94% to 67%. While this means negative ISS recommendations are survivable, successful outcomes are by no means guaranteed. With ISS currently recommending against 12% of say on pay proposals, we expect a significant number of companies to face challenging votes in the very near future.

ISS Pay for Performance Tests Create Unique Challenges

The primary factor driving a majority of negative recommendations from ISS are purported disconnects between CEO pay and company performance. Currently, ISS tests company performance based on 1-year and 3-year total shareholder return ("TSR") against a broad industry comparator group. If a company's 1-year and 3-year TSRs are both below the median of the ISS-established comparator group, and the CEO's year-over-year compensation did not decrease proportionally, ISS will begin a review of compensation practices at the company. If a pay for performance misalignment is identified, then ISS will most likely issue a negative vote recommendation for a company's management say on pay proposal.

The use of broad-brush TSR tests may prove problematic for companies in industries with historically high volatility rates; as sudden stock price swings could have a significant impact on ISS measurements. Furthermore, for companies that rely heavily on large annual equity grants, the current ISS methodology (which counts equity in the year it was awarded, regardless if the grant was made for performance in the prior fiscal year) may create additional concerns. When combined, these two factors make companies in the technology and life sciences sectors particularly susceptible to negative ISS recommendations on say on pay votes.

To stay ahead of the curve, we recommend that clients review annual changes in CEO compensation relative to industry peer group TSR performance. This may help firms anticipate negative ISS recommendations and provide extra time to consider potential responses and/or adjustments to compensation programs.

Beyond TSR-based pay for performance tests, it should be noted that other compensation practices could also trigger a negative recommendation from ISS, whether in conjunction with a TSR problem or independent of an apparent misalignment of executive pay and performance. Some of the most significant "problematic pay practices" include repricing or replacing underwater options without shareholder approval, excessive perquisites or tax gross-ups, and new or extended employment agreements that provide for (1) change-in-control payments exceeding 3 times base salary and bonus; (2) change-in-control payments without involuntary job loss (single triggers) and; (3) change-in-control payments with full or modified tax gross-ups.

Evaluating Cures Offered by ISS

While it is too late to preempt potential issues with ISS by re-drafting CD&A statements covering fiscal year 2010, it is possible to "cure" negative ISS recommendations once they arrive by adjusting the design of long-term incentive based programs. Although companies should evaluate cures on a case-by-case basis, and may ultimately decide not to implement adjustments, potential cures currently provided by ISS include:

1. Companies may amend at least 50% (by share count, not economic value) of the CEO's most recent equity award, granted in either late 2010 or early 2011, to include performance-based vesting conditions. As might be expected, ISS prefers that when adjustments are made they are applied to all named executive officer grants.

2. Companies may commit to adding performance-based vesting conditions to at least 50% (by share count, not economic value) of the CEO's equity award to be issued in 2012. Again, ISS prefers that when adjustments are made they are applied to all named executive officer grants.

Clients should note that in both cases, ISS does not count regular stock options or performance-accelerated awards as performance based. Additionally, ISS requires companies to fully disclose relevant metrics and specific performance targets in order to receive credit for addressing the perceived disconnect between pay and performance. The disclosure of specific performance targets, particularly for the current fiscal year, may be problematic for most organizations. In these cases, companies might consider the use of relative TSR performance measures.

Companies can also address negative ISS recommendations via direct shareholder engagement and/or the publication of additional proxy solicitation materials. Several well-known companies, including GE and Disney, have already adopted these tactics.

Closing Thoughts

With the majority of annual shareholder meetings still to come, the full impact of ISS recommendations on say on pay votes remains to be seen. However, as evidenced by public efforts at firms like Disney and Exxon to combat negative ISS recommendations, it is clear that say on pay related conflicts are already boiling over. We will continue to monitor say on pay trends throughout the 2011 shareholder meeting season and provide you with similar alerts whenever critical issues arise.

As you begin to further examine potential ISS recommendations relating to your company, we encourage you to contact our team with any questions or concerns. To learn more, clients can also visit the Radford Network to access previous alerts on ISS compensation policies, including our December 2010 alert titled "2011 ISS Policy Updates." Additionally, for assistance developing customized tools to monitor 1-year, 3-year and 5-year TSR relative to GICS code peers, clients can contact the Radford Valuation Services group.

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