

Client Alert

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ISS Issues Policy Updates for 2012 Proxy Season

Vital Pay-for-Performance Guidance Still Pending

In a webcast presented today, ISS reviewed its 2012 Policy Updates, which contain several key changes from previous years. Given ISS's growing influence, it is critical that companies and their Boards understand how these policy updates will impact its evaluation of select proxy proposals, including Say on Pay and Director re-election matters.

These final proxy voting policies for 2012 will apply to shareholder meetings held on or after February 1, 2012¹. The vital details about implementation of ISS's most significant policy change – its pay-for-performance test – have not yet been issued, but **ISS has committed to provide additional guidance in a white paper scheduled to be released by December 16th and an updated manual in late January, 2012.**

This Client Alert summarizes four significant compensation² and two related governance changes disseminated so far. Highlights include:

Compensation

- **Pay-for-Performance Test:** In testing for the alignment of CEO pay and company performance, ISS has modified several important aspects of its methodology, including a significant modification to its approach for selecting peer companies.
- **Say on Pay (SOP):** Absent certain actions and disclosures, ISS may recommend a vote against this year's SOP and/or Compensation Committee members (or even the full Board) if a company received less than 70% support on last year's SOP vote.
- **Say on Frequency (SOF):** ISS may recommend a vote against the entire Board if members decide to hold SOP votes less frequently than the timetable approved by a majority of shareholders in the company's previous SOF vote.
- **162(m) Equity Plan Review for Post-IPO Companies:** ISS will review proposals on a case-by-case basis rather than routinely recommending a vote in favor of equity plans submitted by recent IPO companies.

Governance

- **Proxy Access:** ISS incorporated additional factors to its recommendations on shareholder proposals involving proxy access.

¹ The full text of the 2012 proxy voting guidelines and the updates can be reviewed at <http://www.issgovernance.com/policy>.

² We note that ISS has indicated that there will likely be no changes to the list of "problematic pay practices" for 2012. They do, however, intend to update their Governance Risk Indicators (GRId) in the near future.

- **Consideration of Risk Oversight:** ISS added “material failure of risk oversight” as an additional circumstance that could trigger adverse vote recommendations on Directors.

Pay-for-Performance Test

One of the most important changes for 2012 is the modification of ISS’s analysis of the alignment of company performance and CEO pay, or pay-for-performance. Key features of the change include a greater emphasis on long-term performance, refined peer groups, and identification of high performing CEOs who are also relatively highly paid.

2011 Policy:

Previously, ISS identified pay-for-performance disconnects by scrutinizing “underperforming” companies, defined as those with both 1- and 3-year total shareholder return (TSR) below the median of their relevant 4-digit Global Industry Classification Standard (GICS) industry group. ISS also conducted a qualitative examination of other factors, including the year-over-year change in the CEO's total pay and the 5-year trend in TSR and CEO pay, to determine if pay and performance were misaligned. This test only applied to cases where the same CEO was in place for at least two full fiscal years at the time of the meeting.

2012 Policy:

The 2012 Policy continues to use both quantitative and qualitative components. It includes a new peer group methodology that will be generally comprised of 14-24 companies³ selected on the basis of market capitalization, revenue (or assets for financial firms), and 6-digit GICS industry group. The process is designed to produce peers most similar to the subject company, where the subject company is close to median in revenue and asset size. Also, except in extenuating circumstances, new CEOs will not be exempted from the pay-for-performance test; ISS indicates it expects Compensation Committees to be accountable when a company is compelled to significantly “overpay” for new leadership due to prior poor performance. However, it will take into account such circumstances in its qualitative analysis. Specifically, if a company is required to provide high pay to recruit a new CEO, ISS will expect that most of the package be performance-based.

Quantitative Assessment

The quantitative analysis reviews three performance factors in two categories:

1. **Peer Group Alignment:**

- The degree of alignment between the company's TSR rank and the CEO's total pay rank within the peer group, as measured over 1- and 3-year periods (weighted 40/60, to put more emphasis on the long-term performance);
- The multiple of the CEO's total pay relative to the peer group median (this is intended to identify high performing companies that may nevertheless be, in ISS's view, overpaying their CEOs). While ISS does not provide a safe harbor

³ According to ISS’s webcast, in cases where this process generates fewer than 14 similarly sized peers, ISS will institute an alternate systematic approach to developing the peer group.

ratio for this test, it did indicate in its webcast that it will be focusing on “outlier” situations (*i.e.*, those ratios that are over the 90th percentile).

2. Absolute Alignment:

- 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 annual TSR changes during the prior 5-year period).

There is no specific weighting between Peer Group Alignment and Absolute Alignment.

Qualitative Assessment

If the quantitative analysis demonstrates significant misalignment of long-term pay-for-performance, ISS will use the following qualitative factors to assess how various pay elements may have increased or undermined long-term value creation and alignment with shareholder interests:

- The ratio of performance to time-based equity awards;
- The overall ratio of performance-based compensation to fixed compensation;
- The robustness of disclosure and the rigor of performance goals;
- Peer group benchmarking practices;
- Financial/operational metrics, such as growth in revenue, profit, cash flow, etc., both absolute and relative to peers;
- Special circumstances, such as a new CEO in the prior fiscal year or anomalous equity grant practices (e.g., biannual awards); and
- Any other factors that ISS deems relevant.

The 2012 policy appears to be a more systematic approach to identifying alignment issues, although ISS does not anticipate higher negative vote recommendations.

ISS will release additional guidance on the new pay-for-performance model during the week of December 12th. It has also indicated that this publication will provide (on a non-subscription basis) enough information about its comparator methodology that companies should be able to reverse-engineer the ISS peer group to be used for the analysis. However, ISS has indicated that it will not provide a precise list of peers for each company, reasoning that the list often changes during the proxy season.

PM&P Observation: PM&P has continued to express concern about the complexities and problems inherent in the ISS pay-for-performance test. As noted in our recent Comment Letter⁴, we continue to be troubled by the exclusive use of TSR to define company performance; by ISS's general disregard of outcomes from company-selected peer group comparisons; and by the disconnect between compensation considered by ISS in the Summary Compensation Table vs. compensation actually realizable by the CEO.

⁴ See <http://www.pearlmeier.com/Pearl/media/PearlMeyer/PDF/ISSCommentLetteron2012Policy-11-07-11.v2.pdf>

Say on Pay

ISS focused this year's updates on situations in which there is a significant rate of SOP opposition.

2011 Policy:

ISS's previous policy on low voting levels was not very specific, since relatively few companies voluntarily held SOP advisory votes prior to the Dodd-Frank mandate in 2011. Typically, ISS would recommend a vote *against Compensation Committee members (or in rare cases, the full Board)* only: (i) in egregious situations; (ii) if SOP was not on the ballot and ISS found fault with the compensation programs; or (iii) if the company had failed to respond to concerns raised in a prior SOP vote. ISS would recommend on a case-by-case basis *against SOP* if the previous SOP (if any) did not get majority support and the company failed to respond to the concerns expressed by shareholders.

2012 Policy:

The new policy provides more specific parameters as to what ISS will require in the event of what it considers low support for SOP in the 2011 proxy statement. ISS will recommend a vote on a case-by-case basis on: (i) Compensation Committee members; (ii) the full Board (but only in exceptional circumstances)⁵; and (iii) the SOP proposal, if the company's previous SOP vote received the support of **less than 70 percent** of votes cast.

The recommendation will take into account:

- The company's response, including:
 - Disclosure of engagement efforts with major institutional investors regarding the issues that contributed to the low level of support;
 - Specific actions taken by the company to address issues underlying the low level of support;
 - Other recent compensation actions by the company;
- Whether the program issues raised were recurring or isolated;
- The company's ownership structure; and
- Whether the support level was less than 50 percent, which ISS said would warrant its highest degree of responsiveness.

Under the Dodd-Frank Act, future CD&As will need to address if and how the company's compensation policies and decisions took into account the results of the most recent SOP vote. ISS will require companies receiving significant opposition votes to go one step further – they must provide substantive and meaningful disclosure regarding whether the company has taken sufficient actions to address the problematic compensation issues. ISS recommends companies conduct outreach efforts with major institutional investors to find out why they voted against the SOP, and provide specific actions they have taken to address the issues that resulted in the opposition vote. ISS makes further recommendations regarding the company's response and related disclosures, including: *not* reiterating existing practices; avoiding boilerplate language; and requiring that all responses be readily accessible to investors reading the proxy statement.

⁵ ISS has indicated that similar to 2011, it will use SOP as the primary vehicle for expressing dissatisfaction with pay programs, with recommendations against Committee members and/or other Directors possible in egregious situations.

PM&P Observation: Companies receiving more than *de minimis* opposition (even if less than 30% opposition) should already be engaging their institutional shareholders regarding their reasons for the negative votes and to what extent program changes could help secure positive votes in the future. Such changes (or the rationale for lack of changes) should be prominent in the CD&A for 2012 – or even prior to the next proxy season. Of the 40 companies that failed to obtain majority support in 2011 SOP votes to date, at least eight have filed Form 8-Ks indicating corrective actions they have taken.

In addition, rigorous disclosure is critical not only for securing ISS and shareholder approvals, but also as a litigation matter. As of this Client Alert, shareholders at seven of the 40 companies that failed SOP have filed derivative suits alleging there was a breach of fiduciary duty by Directors, and more are likely.

Finally, we note that the 2012 Policy may increase the influence of ISS in a way that does not benefit or align with shareholders' interests. For example, if ISS recommended a vote against a company's SOP in 2011 due to perceived problems with a specific pay practice, the company was likely to obtain favorable approval in the range of 70%, rather than the average 90%. Going forward, if such a company does not change the policy that elicited poor ISS response in 2011, ISS will recommend a vote against the SOP, but may also issue a recommendation against the reelection of Committee members in the second year, **despite the fact that a majority of shareholders supported the 2011 SOP vote.**

Say on Frequency

Under Dodd-Frank, public companies must give shareholders an advisory vote on how frequently to hold SOP votes at the first annual shareholder meeting on or after January 21, 2011, and at least every six years thereafter. Shareholders can vote to hold SOP votes every year, every two years, or every three years. Because 2011 was the first year for SOF, ISS did not have a policy that reacted to which frequency was adopted by companies.

2012 Policy:

ISS will recommend against or withhold votes from incumbent Directors if they schedule future SOP votes *less frequently* than the timetable that received majority support in the previous SOF vote. If no frequency received a majority, ISS will provide vote recommendations on a case-by-case basis if the Board implements SOF on a less frequent basis than the *plurality* vote, taking into account:

- The Board's rationale for not choosing the frequency supported by a plurality of votes;
- The company's ownership structure;
- Whether ISS's analysis of the company's executive compensation reveals concerns or a history of problematic compensation practices; and
- The previous year's level of support for SOP.

PM&P Observation: We do not anticipate the new SOF policy will be an issue for most companies. As of this Client Alert, most companies have adopted the same or a more frequent SOP vote than was approved by the majority of

shareholders. The few companies that have chosen to implement a less frequent vote should be prepared to provide a strong rationale in their CD&As.

162(m) Equity Plan Review for Post-IPO Companies

The 2012 Policy creates a more rigorous screen for the initial approval of equity plans under Section 162(m) of the Internal Revenue Code (the \$1 million limit on non-performance-based pay). ISS believes this policy is better aligned with a proposed Treasury ruling that requires recent IPO companies to obtain shareholder approval before awarding certain performance-based restricted stock units to named executive officers covered by Section 162(m) before the end of their standard transition period in order to qualify them as performance-based.

2011 Policy:

As a general matter, ISS did not focus on equity plans of recent IPO companies.

2012 Policy:

ISS will no longer give a blanket approval recommendation to equity plans submitted for 162(m) purposes, even for a company that only recently went public. Instead, the plan will be subject to a full equity plan evaluation by ISS that includes consideration of:

- Total shareholder value transfer (the “SVT test”);
- Burn rate, if applicable;
- Repricing provisions;
- Liberal change-in-control provisions; and
- Pay-for-performance or problematic pay practices related to SOP outcomes.

PM&P Observation: While ISS anticipates it will continue to support the vast majority of Section 162(m) proposals that do not seek additional shares, newly public companies should be prepared for ISS’s standard comprehensive examination of their equity plans. This will involve a review not only of the cost of the compensation program, but other design and pay practices.

Proxy Access

On September 20, 2011, the SEC’s amendment to Rule 14a-8 took effect. This Rule provides that companies may not exclude shareholder proposals for proxy access from their proxy materials. In anticipation of potentially more frequent proxy access shareholder proposals in the coming months, ISS has expanded and clarified its considerations for assessing shareholder proposals seeking open or proxy access.

2011 Policy:

ISS’s current policy on shareholder proposals asking for open or proxy access is to make a recommendation on a case-by-case basis taking into account:

- The ownership threshold proposed in the resolution; and
- The *proponent’s* rationale for the proposal at the targeted company in terms of Board and Director conduct.

2012 Policy:

ISS will continue to evaluate these proposals individually, but believes the former policy did not take into consideration management proposals and over-emphasized the proponents' rationale. The expanded list of factors to be considered will now include:

- Company-specific factors
- Proposal-specific factors, including:
 - The percentage and duration in the ownership threshold proposed
 - The maximum number of directors that shareholders may nominate each year
 - The method of determining which nominations should appear on the ballot if multiple shareholders submit nominations

During the comment period on this rule, companies requested more specificity and further guidance. ISS has indicated that further guidance **will be released in January 2012** in the form of FAQs or other reports, after it has reviewed specific proposal texts.

As of this writing, we are aware of two proxy access proposals submitted for this season so far. Both were filed by Ken Steiner, an individual shareholder activist associated with the U.S. Proxy Exchange, and were submitted to Textron Inc. and MEMC Electronic Materials, Inc. The proposals would permit Director nominees from: (i) any party of one or more shareowners that has continuously held stock for two years that accounts for at least 1% of the securities eligible to vote in the Director election; and/or (ii) any party of 100 or more shareowners that satisfies SEC Rule 14a-8(b) eligibility requirements (i.e., those who hold at least a \$2,000 stake continuously for one year). Any eligible party may make one Director nomination or, if greater, a number of nominations equal to 12 percent of the current number of Board members, rounding down.

PM&P Observation: The standard included in the proxy access proposals noted above represent a lower threshold of stock ownership than the SEC's market-wide Proxy Access Rule, which was vacated by court order in September of this year. It would have required ownership of 3% of a company's outstanding shares for a period of 3 years. Since there are likely to be a growing number of proxy access proposals this year, companies and Boards should closely follow any trends in the proposals as well as levels of shareholder and ISS support.

Heightened Emphasis on Risk Oversight

ISS has expanded the factors it considers in its Director voting assessment to specifically include material failure in risk oversight.

2011 Policy:

Under extraordinary circumstances, ISS may issue a negative vote recommendation for individual Directors, Committee members, or the entire Board, due to:

- Material failures of governance, stewardship, or fiduciary responsibilities at the company;
- Failure to replace management as appropriate; or
- Egregious actions related to the Director(s)' service on other Boards that raise substantial doubt about his or her ability to effectively oversee management and serve the best interests of shareholders at any company.

2012 Policy:

“Risk oversight” is specifically added to the standard for determining a material failure by the Board of governance, stewardship, or fiduciary responsibilities.

Conclusions

Of all the new updates to ISS’s policies, changes to the pay-for-performance test will have the greatest impact on companies as we approach the 2012 proxy season. Unfortunately, while the detailed methodologies will not be disseminated until nearly the end of the year, companies face more immediate deadlines for making compensation decisions that will directly impact the outcome of the test and, ultimately, ISS’s proxy voting recommendations. As we have previously pointed out to ISS, its own methodology for evaluating performance and peer group selection may vary dramatically from that used by a particular company. Even more problematic, the required Dodd-Frank disclosures around pay-for-performance that are anticipated to go into effect next year may vary significantly from the assessment used by ISS.

At this point, companies should be prepared to run the ISS model as soon as further guidance is issued in order to understand the extent to which the quantitative aspects of the new test could pose problems. We recommend that companies be prepared to counter potential concerns with investor outreach and more robust CD&A disclosures that will justify their pay and performance practices using their own methodologies.

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**NEW YORK**

570 Lexington Avenue
New York, NY 10022
(212) 644-2300
newyork@pearlmeyer.com

ATLANTA

One Alliance Center
3500 Lenox Road, Suite 1708
Atlanta, GA 30326
(770) 261-4083
atlanta@pearlmeyer.com

BOSTON

132 Turnpike Road, Suite 300
Southborough, MA 01772
(508) 460-9600
boston@pearlmeyer.com

CHARLOTTE

3326 Siskey Parkway, Suite 330
Matthews, NC 28105
(704) 844-6626
charlotte@pearlmeyer.com

CHICAGO

123 N. Wacker Drive, Suite 860
Chicago, IL 60606
(312) 242-3050
chicago@pearlmeyer.com

HOUSTON

Three Riverway, Suite 1575
Houston, TX 77056
(713) 568-2200
houston@pearlmeyer.com

LOS ANGELES


550 S. Hope Street, Suite 1600
Los Angeles, CA 90071
(213) 438-6500
losangeles@pearlmeyer.com

SAN FRANCISCO

455 Market Street, Suite 2000
San Francisco, CA 94105
(415) 651-4560
sanfrancisco@pearlmeyer.com

SAN JOSE

2880 Zanker Road, Suite 203
San Jose, CA 95134
(408) 954-7399
sanjose@pearlmeyer.com



www.pearlmeyer.com