

Client Alert

February 5, 2014

Updated ISS Policies for 2014: Compensation Voting Policy FAQs, Data Verification Dates in QuickScore 2.0 and New Burn Rates

Two new pieces of guidance have already emerged in 2014 from advisory firm Institutional Shareholder Services (ISS). This Client Alert updates our previous Alert of December 9, 2013¹ with additional technical information including:

- **Updated Compensation Voting Guidelines and New FAQs:** ISS finalized its 2014 proxy voting guidelines in November 2013², generally applicable to shareholder meetings held on or after February 1, 2014. Since that time, ISS has released several FAQ updates from 2013 that are highlighted in this Alert.³
- **Governance QuickScore 2.0 and Window Period for Review:** ISS updated QuickScore, its quantitatively-driven scorecard designed to identify governance risk in four categories, including compensation.
 - ISS set a February 7 deadline for companies to confirm the information and data used in their QuickScore analysis.
- **Updated Burn Rates for 2014:** ISS finalized its annual burn rate caps for Russell 3000 and Non-Russell 3000 companies by GICS groups, which influence its voting recommendations on new or amended equity plans.

2014 Compensation Voting Policy

This section summarizes the minor changes ISS made to its pay-for-performance (PFP) test and the updates to the FAQs meant to clarify some aspects of the test.

Pay-for-Performance Test

The PFP test is fundamental to ISS's Say on Pay voting recommendations and consists of a quantitative analysis and a qualitative assessment.

¹ See <http://www.pearlmeier.com/Pearl/media/PearlMeyer/ClientAlerts/PMP-CA-ISS2014Policies-12-9-2013.pdf>

² See <http://www.issgovernance.com/files/2014USPolicyUpdates.pdf>

³ See <http://www.issgovernance.com/files/ISSUSCompensationFAQs12192013.pdf>

Quantitative Analysis

The newly revised analysis consists of three factors sorted by two alignment categories:

1. Peer Group Alignment:

- *The relative degree of alignment (RDA) between the company's TSR rank and the CEO's total pay rank within the peer group. **Going forward, ISS will no longer consider the 1-year period, as discussed below.** Previously, the RDA was reviewed over both 1- and 3-year periods, which were weighted 40/60, respectively, to emphasize long-term performance.*
- *The multiple of CEO total pay relative to the peer group median. This is intended to identify high-performing companies where ISS nevertheless considers the CEO to be overpaid.*

2. Absolute Alignment:

- *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 of annual pay changes and the trend of annualized TSR during the prior 5-year period).*

The only changes in the quantitative screen for 2014 is that ISS will no longer consider the RDA between a company's 1-year TSR and the CEO's 1-year total pay rank. Instead, this metric will be completely based **on the RDA of the company's annualized TSR and the CEO's annualized total pay rank, each measured over a 3-year period.** At companies lacking pay and performance data available for all three years, RDA will be measured in each of the full fiscal years in which the company was publicly-traded and disclosed pay data.

Qualitative Assessment

If the quantitative analysis results in a "high" or "medium" level of concern for alignment of long-term PFP, ISS will perform a qualitative assessment to determine how various pay elements may have increased or undermined long-term value creation and alignment with shareholder interests. ISS added realizable pay in 2013 as a qualitative factor to be considered for "large cap" (i.e., S&P 500) companies. In 2014, consideration of realizable pay will be expanded to include the S&P 1500.

The complete list of factors for the 2014 qualitative assessment includes:

- 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;
- 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 such as appointment of a new CEO in the prior fiscal year or anomalous equity grant practices (e.g., biannual awards);
- **Realizable pay compared to granted pay for S&P 1500 companies (only applied to S&P 500 companies 2013);** and
- Any other factors that ISS deems relevant.

Several new FAQs provide some clarity on ISS's qualitative assessment:

- "Low" Quantitative Concern Still Warrants Qualitative Review: Even if a company received a "low" concern in the quantitative test, ISS may still evaluate the company's incentive programs for problematic practices which could ultimately result in a negative recommendation.
- Performance vs. Fixed Compensation: ISS clarified that even if a company issues time-based stock awards based on specific performance criteria, it will only consider such awards to be performance-based if the goals and measures were pre-established and disclosed in the proxy statement in the year in which the performance period began.
- Position on Acceleration of Equity upon Change-in-Control (CIC): ISS clarifies that absent a liberal definition of CIC, it does not maintain a specific policy regarding accelerated vesting provisions in an equity plan proposal. However, ISS expressed clear disdain for full acceleration of equity awards absent a termination of employment, especially if the awards were performance-based. It suggests that a better approach to single-trigger full acceleration is to provide for the assumption or conversion to equivalent awards of the acquiror's equity. In an all-cash transaction, ISS suggests that vested time-based equity awards retain their original vesting schedules, post-conversion to the cash consideration, so that the converted cash awards remain subject to the executive's continued service (and only accelerate if employment is terminated in connection with the CIC). It also recommends that unvested performance-based equity awards be vested pro rata and adjusted for actual performance and the fractional performance period, to appropriately reward for actual performance. Finally, ISS suggests that Compensation Committees can adjust performance goals in good faith to account for a shortened performance period, with equivalent cash conversions being based on this adjustment.

Governance QuickScore 2.0

Overview

"QuickScore," the ISS platform initially introduced in the 2013 proxy season, is intended to produce quantitatively-driven data for identifying governance risk within companies, based on companies' decile ranking in their home region.

Categories and Questions

Scoring will be applied over the same four “pillars” as last year, with several subcategories in each pillar, plus one additional subcategory added this year for “Other Audit Issues” under the Audit Practices pillar:

Board Structure (5)	Compensation (7)	Shareholder Rights (4)	Audit Practices (3)
<ul style="list-style-type: none"> Board Composition Committee Composition Board Practices Board Policies Related Party Transactions 	<ul style="list-style-type: none"> Pay- for-Performance Non-Performance Based Pay Use of Equity Equity Risk Mitigation Communications & Disclosure Termination Controversies 	<ul style="list-style-type: none"> One Share One Vote Takeover Defenses Voting Issues Voting Formalities 	<ul style="list-style-type: none"> External Auditor Audit and Accounting Controversies Other Audit Issues

Specific compensation questions within each subcategory for the U.S. market are listed in Appendix A, with changes for 2014 highlighted in red. ISS notes that some of the new factors will have zero weight, meaning they are intended to provide additional insight into the governance structures and practices of companies but will not affect a company’s score.

New compensation-related questions for 2014 include:

- What is the degree of alignment between the company’s 3-year pay % rank relative to peers, and its 3-year annualized TSR rank relative to peers (updated to exclude 1-year factor)?
- Did the most recent SOP proposal receive less than the industry-index level of shareholder support?
- What is the average size of outside Director compensation as a multiple of the median of company peers?

Methodology

Once again, ISS did not provide a detailed formula for QuickScore. The information available indicates that ISS will continue to:

- Use a quantitative approach with specific weightings for each factor, based on its correlation with 16 key performance and risk metrics (with a higher correlation indicating a higher weighting). These weightings have been adjusted from last year, with some factors moving between pillars, though that specific information is not available to the public. The metrics remain as follows:

Market (2)	Profitability (9)	Risk (2)	Valuation (3)
<ul style="list-style-type: none"> Industry Adjusted TSR1Y Tobin’s Q 	<ul style="list-style-type: none"> Cash Flow ROI 1-year Dividend Growth EBITDA Margin Free Cash Flow vs. Sales Net Profit Margin ROA, ROE & ROIC 1-year Sales Growth 	<ul style="list-style-type: none"> Volatility Z Score 	<ul style="list-style-type: none"> Price to Book Ratio Price to Cash Flow Ratio Price to Earnings Ratio

- Produce a numeric, decile-based score of a company's relative rank in its region, with "1" indicating a higher raw score and lower governance risk. Companies will continue to be assessed on four "pillars" and receive an overall Governance QuickScore and assessment.
- Provide high-level flagging within each subcategory, with green stars and red flags indicating positive and negative impact, respectively. These markers are given on an absolute basis and are thus not indicative of actual scores, which are dictated on a relative region basis.

Data Verification Process

ISS gives companies an opportunity to verify the data used for the QuickScore 2.0 platform, with the following key dates:

- January 27: ISS opened its data verification site for companies to review their data against the Governance QuickScore 2.0 factors
- February 7: ISS will close down the verification site
- February 18: ISS Governance QuickScore 2.0 will officially launch, and scores will be available

Additionally, QuickScore 2.0 will now use "event driven data," by pulling recent public filings to proactively track and update a company's governance structures. These changes will then be integrated into the Company's QuickScore on a timely ongoing basis.

PM&P Observation: Companies should continue to monitor their QuickScore 2.0 inputs, particularly after any significant public filings. Companies are encouraged to review the information and data on which ISS is basing its calculation in order to respond before the verification site is closed on February 7⁴.

2014 Burn Rates

ISS will vote against a new or amended equity plan if the company's 3-year average burn rate exceeds the greater of: (1) the mean plus one standard deviation of the company's GICS group segmented by Russell 3000 index and non-Russell 3000 index; and (2) 2% of the weighted common shares outstanding. The new 2014 policy guidelines continue to limit the annual changes in the threshold to plus or minus 2% of the previous year's thresholds.

⁴ The verification site can be found at: <http://www.issgovernance.com/quickscore/dataverification>

Updated 2014 burn rate caps for Russell 3000 and Non-Russell 3000 GICS groups are shown below, alongside 2013 rates and the year-over-year changes:

Burn Rate Caps

GICS	Description	Russell 3000		Delta	Non-Russell 3000		Delta
		2013	2014		2013	2014	
1010	Energy	4.57%	4.30%	-0.27%	9.46%	7.46%	-2.00%
1510	Materials	3.08%	2.85%	-0.23%	8.04%	7.85%	-0.19%
2010	Capital Goods	3.70%	3.20%	-0.50%	6.69%	8.16%	1.47%
2020	Commercial & Professional Services	4.74%	4.37%	-0.37%	7.28%	7.33%	0.05%
2030	Transportation	3.21%	3.33%	0.12%	4.88%	3.69%	-1.19%
2510	Automobiles & Components	3.28%	3.81%	0.53%	7.60%	5.95%	-1.65%
2520	Consumer Durables & Apparel	4.83%	4.28%	-0.55%	7.01%	7.61%	0.60%
2530	Consumer Services	3.88%	4.16%	0.28%	4.99%	4.28%	-0.71%
2540	Media	5.60%	4.43%	-1.17%	6.29%	5.47%	-0.82%
2550	Retailing	3.93%	4.16%	0.23%	5.61%	6.60%	0.99%
3010, 3020,3030	Consumer Staples	2.82%	2.77%	-0.05%	5.17%	4.45%	-0.72%
3510	Health Care Equipment & Services	5.09%	4.82%	-0.27%	9.92%	9.08%	-0.84%
3520	Pharmaceuticals & Biotechnology	6.70%	5.91%	-0.79%	10.58%	8.98%	-1.60%
4010	Banks	2.75%	3.13%	0.38%	2.28%	2.79%	0.51%
4020	Diversified Financials	9.53%	8.74%	-0.79%	9.56%	7.56%	-2.00%
4030	Insurance	3.02%	3.30%	0.28%	2.38%	2.58%	0.20%
4040	Real Estate	3.25%	2.86%	-0.39%	3.09%	2.68%	-0.41%
4510	Software & Services	7.26%	7.25%	-0.01%	9.58%	9.14%	-0.44%
4520	Technology Hardware & Equipment	5.77%	5.49%	-0.28%	8.53%	8.91%	0.38%
4530	Semiconductor Equipment	6.58%	6.72%	0.14%	10.55%	9.75%	-0.80%
5010	Telecommunications	4.85%	4.22%	-0.63%	8.75%	7.54%	-1.21%
5510	Utilities	2.00%	2.00%	0.00%	4.99%	3.66%	-1.33%

Among the 22 Russell 3000 GICS groups, year-over-year change was a modest -.2% on average. Burn rate caps increased slightly for about a third of the Russell 3000 companies, notably by +.53% in Automobiles & Components. The largest decline in burn rate caps was in Media at -1.17%. The Non-Russell 3000 companies saw minor decline averaging -.53%, with the biggest changes of +1.47% in Capital Goods and -2.0% in two GICS groups, Energy and Diversified Financials.

Conclusion

ISS has made relatively few policy changes for 2014 compared to past years, particularly on the compensation side. At this point, companies are encouraged to review their ISS Governance QuickScore by the February 7th deadline in order to correct any errors prior to publication. Companies should also continue to monitor the QuickScore data verification site when new regulatory filings and other governance-related disclosures are released.

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Appendix A

QuickScore Compensation Questions for U.S. Markets (Questions in **red** have been added to the original QuickScore factors)

Pay-for-Performance (7)

- What is the degree of alignment between the company's cumulative 3-year pay percentile rank, relative to peers, and its 3-year cumulative TSR rank, relative to peers?
 - *This factor has a zero-weight impact on the scoring model and is included for informational purposes only.*
- What is the degree of alignment between the company's cumulative 1-year pay percentile rank, relative to peers, and its 1-year cumulative TSR rank, relative to peers?
 - *This factor has a zero-weight impact on the scoring model and is included for informational purposes only.*
- What is the size of the CEO's 1-year total pay, as a multiple of the median pay for company peers?
- What is the degree of alignment between the company's TSR and change in CEO pay over the past five years?
- What is the ratio of the CEO's total compensation to the next highest paid executive?
- **What is the degree of alignment between the company's annualized 3-year pay percentile rank, relative to peers, and its 3-year annualized TSR rank, relative to peers?**
- **Did the most recent Say on Pay proposal receive shareholders' support below the industry-index level?**

Non-Performance Based Pay (2)

- Are any of the NEOs eligible for multiyear guaranteed bonuses?
- What is the ratio of the CEO's non-performance-based compensation (All Other Compensation) to Base Salary?

Use of Equity (7)

- Do the company's active equity plans prohibit share recycling for options/SARS?
- Do the company's active equity plans prohibit option/SAR repricing?
- Does the company's active equity plans prohibit option/SAR cash buyouts?
- Do the company's active equity plans have an evergreen provision?
- Do the company's active equity plans have a liberal CIC definition?
- Has the company repriced options or exchanged them for shares, options or cash without shareholder approval in the last three years?
- Does the company grant equity awards at an excessive rate, according to ISS policy?

Equity Pay Risk Mitigation (10)

- Did the company disclose a claw back or malus provision?
- What are the minimum vesting periods mandated in the plan documents for executives' stock options or SARS in the equity plans adopted/amended in the last three years?
- What are the minimum vesting periods mandated in the plan documents adopted/amended in the last three years for executives' restricted stock?
- What is the holding period for stock options (for executives)?
- What is the holding period for restricted shares (for executives)?

- What proportion of the salary is subject to stock ownership requirements/guidelines for the CEO? Is the CEO subject to ownership guidelines?
- Are Directors subject to stock ownership guidelines?
- Do all Directors with more than one year of service own stock?
- Did any executive or Director pledge company shares?
- Does the company have a policy prohibiting hedging of company shares by employees?

Communications and Disclosure (2)

- What is the level of disclosure on performance measures for the short-term incentive plan?
- What is the level of disclosure on performance measures for the latest active or proposed long-term incentive plan?

Termination (6)

- What's the trigger under the CIC agreements?
- What is the multiple of salary plus bonus in the severance agreement for the CEO (upon a CIC)?
- What is the basis for the CIC or severance payment for the CEO?
- Does the company provide excise tax gross-ups for CIC payments?
- What is the length of employment agreements with the CEO?
 - *This factor has a zero-weight impact on the scoring model and is included for informational purposes only.*
- Do equity-based plans or long-term cash plans vest completely on a CIC?

Controversies (2)

- Has ISS's qualitative review identified a PFP misalignment?
- Has ISS identified a problematic pay practice or policy that raises concerns?



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