Newly-Public Companies and the ISS "Pay for Performance" Analysis

In 2011, Institutional Shareholder Services ("ISS"), the prominent corporate governance advisory services firm, made significant revisions to its CEO "pay for performance" analytics as part of its updates to its U.S. corporate governance policies for the 2012 proxy season. ISS is applying this revised analysis primarily in formulating its voting recommendation for shareholder advisory votes on executive compensation (the so-called "Say on Pay" votes) that are now required by the Dodd-Frank Wall Street Reform and Consumer Protection Act, but also potentially to other shareholder votes, including director elections and approval of equity plans.

Although the recently-enacted "Jumpstart Our Business Startups (JOBS) Act" exempts so-called "emerging growth companies" (that is, newly-public companies with annual gross revenues of less than $1 billion) from the Say-on-Pay vote requirement, the exemption is only available if the company's initial public offering of equity securities was completed on or after December 8, 2011. Thus, companies that completed their IPO before December 8, 2011 must conduct a Say-on-Pay vote at least once every three years (as determined with input from a company's shareholders). This article examines how ISS will apply this CEO "pay for performance" analysis to both regular companies and emerging growth companies in the first four full fiscal years following their IPO.

The ISS CEO "Pay for Performance" Analysis

As part of its annual review of executive (primarily CEO) compensation, ISS evaluates the effectiveness of a company's executive compensation program to determine whether the company has demonstrated strong, satisfactory, or weak alignment between its financial performance and executive compensation over an extended period. Through this analysis, ISS assigns each company with a "high," "medium," or "low" level of concern.

The analysis consists of both a quantitative and qualitative review. Initially, ISS conducts a quantitative review of both relative and absolute "pay for performance" alignment using the following tests:

Relative Alignment

First, ISS compares the following measures against a group of ISS-defined peer companies:

- Multiple of Median ("**MOM**"): the multiple of the CEO's one-year total pay relative to the peer group median; and
- Relative Degree of Alignment ("**RDA**"): the degree of alignment between the company's total shareholder return ("TSR") ranking and the CEO's total compensation ranking within the peer companies over one-year and three-year periods.

Absolute Alignment

Then, ISS conducts the following assessment:

- Pay-TSR Alignment ("**PTA**"): the long-term alignment between the CEO's total compensation and the company's TSR, based on trends in both items over the preceding five fiscal years.

If the results of these reviews produce an overall "high" level of concern, ISS then conducts a qualitative review to determine its final vote recommendation. This review potentially considers a number of factors (as enumerated in the next section).

Applying the "Pay for Performance" Analysis to Newly-Public Companies

Due to data limitations, ISS will not always be able to apply each of the quantitative tests described above to companies whose equity securities have been publicly-traded for less than four full fiscal years. The following chart illustrates how ISS will phase in these tests for newly-public companies during the first four full fiscal years after their IPO:

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Newly-Public Companies and the ISS "Pay for Performance" Analysis (continued)

Years from IPO*	MOM	RDA 1-year	RDA 3-year	PTA
<1	Case by Case	No	No	No
1 to <3	Yes	Yes	No	No
3 to <4	Yes	Yes	Yes	No
4+	Yes	Yes	Yes	Yes

* Reflects full fiscal years as a publicly traded company from the IPO date

For example, a company with a calendar fiscal year end that completed its IPO in mid-2011 will be subject to a limited (if any) quantitative review in connection with its 2012 annual meeting of shareholders. ISS may only, on a (presumably) discretionary basis, review the 2011 compensation of the company's CEO versus the peer group median (even though a portion of the CEO's compensation may have been provided while the company's securities were still privately-held). We have noted a handful of instances where ISS has taken this approach where a company that completed its IPO during 2011 was included in the Russell 3000 index as of its year-end December update. On the other hand, for a similar company that completed its IPO in mid-2010, ISS will conduct a limited quantitative review that consists of the MOM test and the one-year RDA test.

When unable to complete a full or partial quantitative review for purposes of the "pay for performance" analysis or when a quantitative review results in a "high" level of concern, ISS will conduct its qualitative review, which may involve some or all of the following factors:

- the ratio of performance-based to time-based equity awards (it is important to note that ISS does not consider stock options with solely time-based vesting requirements to be "performance-based" equity);
- the ratio of performance-based compensation to overall compensation;
- the completeness of the company's disclosure and the rigor of any performance goals;
- the company's peer group benchmarking practices;
- the actual results of financial and operational measures (such as growth in revenue, profit, cash flow) analyzed on both an absolute and relative basis against the company's peers;
- any special circumstances that may exist (such as a new CEO or non-annual equity award practices); and
- any other factors deemed relevant (such as the rationale for CEO compensation and the size of pay changes).

Observations: Newly-public companies should familiarize themselves with how the ISS quantitative tests are being phased in over the four full fiscal year period following their IPO and the tests' potential application to their specific situation. In our experience, CEO compensation decisions (including the timing, size, and form of any equity awards) will begin to impact the company's standing in these tests starting in the year of the IPO. In particular, this understanding will be most relevant to companies where share ownership is more widely dispersed, which, unlike companies with concentrated insider ownership or a dual class stock structure, are at greatest risk for an unfavorable Say-on-Pay vote or high levels of shareholder dissent on other compensation-related matters, such as the election of directors who have served as members of the board's compensation committee.

While there are no immediate legal implications associated with an unfavorable ISS recommendation on a Say-on-Pay proposal, such a recommendation can have reputational repercussions for a company and its board of directors (particularly members of the compensation committee) and, if it leads to a failed Say-on-Pay vote, may exacerbate this problem and, under a worst case scenario, result in litigation.

Even though ISS appears to be streamlining its qualitative review in the first year after an IPO, we have seen companies that are considering an IPO or newly-public companies evaluate one or more of the following actions to, in part, enhance their standing in any qualitative ISS review:

- Develop a defensible peer group and guiding principles for compensation benchmarking;
- Design a rigorous, objective short-term (annual) incentive plan;
- Implement a performance-based equity program where the earn-out of all or certain executive awards are tied to absolute or relative financial, operational or stock price performance objectives; and
- Adopt stock ownership guidelines and/or a compensation recovery ("clawback") policy.

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It is important to note that, as of June 7, 2012, ISS had issued only one "against" recommendation for the initial Say-on-Pay proposals at the 23 technology companies that completed their IPOs in 2011 and subsequently held their initial annual meeting of shareholders. (We believe that this recommendation may have been based largely on concerns about a significant cash compensation package (in excess of $20 million) awarded to a new executive coupled with a significant net loss in the same fiscal year.)

This is in marked contrast to the "against" recommendations that ISS had issued to 14% of the Russell 3000 companies on their Say-on-Pay proposals during the same period. It appears that ISS is conducting a less rigorous review of the executive compensation programs of newly-public companies (at least when it comes to their initial Say-on-Pay proposal) which may be due, in large part, to insufficient data about long-term public company pay and stock price performance. To remain on top of this area, newly-public companies should monitor any changes to ISS' U.S. corporate governance policies (which, typically, are published each year in November).

Implications of JOBS Act on ISS' "Pay for Performance" Analysis

The provisions in the JOBS Act governing emerging growth companies will also impact ISS" review of the executive compensation programs of newly-public companies. Under the JOBS Act, emerging growth companies are permitted to provide a minimal level of disclosure about their executive compensation program in their initial registration statement on Form S-1 and subsequent proxy materials (essentially, an abbreviated Summary Compensation Table, an Outstanding Equity Awards at Fiscal Year-End Table, and a Director Compensation Table). Most importantly, emerging growth companies are not required to provide a Compensation Discussion and Analysis. In addition, emerging growth companies are exempt from conducting a Say-on-Pay vote for at least three years. While the JOBS Act permits a newly-public company that qualifies as an emerging growth company to elect to provide full (or even partial) executive compensation disclosure in its SEC filings and/or conduct Say-on-Pay votes, so far we have not seen any such companies opt for this alternative.

Observations. Although not required, we believe that, eventually, we may see a newly-public company that qualifies as an emerging growth company elect to conduct a Say-on-Pay vote at its initial annual meeting of shareholders where it concludes that its executive compensation decisions may make the members of its board of directors vulnerable to an "against" or "withhold vote" recommendation. In evaluating the merits of this approach, we expect a company to consider (a) its ownership structure, (b) the length of director terms and the board's classification, (c) the applicable vote standard for director elections (that is, plurality versus majority), and (d) the company's assessment of the potential downside (both in terms of optics and reputation) for "against" or "withhold" votes for directors versus the outcome of the Say-on-Pay proposal.

Even emerging growth companies that fully intend to avail themselves of the streamlined disclosure permitted under the JOBS Act should be sensitive to the fact that it will be significantly more difficult for ISS to conduct a qualitative review of their executive compensation program given the minimal disclosure that is required (primarily the absence of a CD&A). Thus, where an emerging growth company believes that the members of its board of directors may be at risk for an "against" or "withhold vote" recommendation, it should consider whether enhanced executive compensation disclosure (beyond the disclosure required by the JOBS Act even if not the full disclosure required of regular companies) will help improve the potential outcome of any qualitative review by ISS of the company's executive compensation policies and decisions.

As the treatment of emerging growth companies by ISS is just beginning, newly-public companies will want to monitor ISS' policy updates for the 2013 proxy season to see whether (and, if so, how) it addresses the challenges presented in applying its analytics to such companies.

About the Authors

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Need Assistance?

Compensia has had significant experience in helping companies to address the implication of ISS' policies. If you have any questions on the subjects addressed in this Thoughtful Pay Alert or would like assistance, please feel free to contact Mark Borges, Jason Borrevik, or Aaron Johansen. ■

About Compensia

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