ISS Issues 2012 Policy Updates

Institutional Shareholder Services, the prominent corporate governance advisory services firm, has updated its U.S. corporate governance policies for 2012. In the aftermath of the first proxy season involving a mandatory shareholder advisory vote on executive compensation (the so-called "Say-on-Pay" vote), this latest annual update addresses several significant matters, including a revised "pay for performance" analysis for evaluating the link between corporate financial performance and executive pay and how ISS will assess a company's response to its initial Say-on-Pay vote. As in prior years, this update reflects the changes being made to the corporate governance and executive compensation policies that ISS will use to determine its voting recommendations for its proxy advisory clients during the upcoming 2012 proxy season.

The ISS' Benchmark U.S. Corporate Governance Policies can be accessed at www.issgovernance.com/policy.

The updated policies are effective for shareholder meetings held on or after February 1, 2012.

Significance of Policies

As a long-time advisor to the institutional investor community, ISS is the bellwether for the key shareholder issues to be addressed each proxy season. ISS regularly publishes annual updates to its standards on good corporate governance and executive compensation policies and practices. These standards, which are contained in a series of policy statements, including a comprehensive "Executive Compensation Evaluation" policy statement, are used by ISS to formulate the voting recommendations that it provides to its clients for the election of directors, the shareholder advisory vote on executive compensation required by the Dodd-Frank Wall Street Reform and Consumer Protection Act, and other proposals submitted for shareholder action at annual shareholders' meetings, as well as to analyze companies' corporate governance and executive compensation policies and practices.

While most technology and life sciences companies focus on the policy updates that affect their corporate governance structure and executive compensation programs, the updates actually encompass a broader range of social

Four Things Technology and Life Sciences Companies Should Know About the 2012 Policy Updates

- "Pay for Performance" Analysis – ISS has significantly revamped its "pay for performance" analytics to reflect a more extensive evaluation of CEO pay and total shareholder return on a relative basis against an ISS-developed peer group and on an absolute basis over a five-year period. Where "weak" alignment is identified, ISS will conduct a qualitative assessment of the executive compensation program to determine casual or mitigating factors for purposes of making its voting recommendations on compensation-related proposals
- Say-on-Pay Vote – Where a company has received less than 70% support for its 2011 Say-on-Pay proposal, ISS will closely evaluate the company's response to the vote and may recommend "against" the current Say-on-Pay proposal and the re-election of the compensation committee members if the response is deemed inadequate.
- Section 162(m)-Related Equity Plan Proposals – Equity plans of newly-public companies being submitted for shareholder approval solely for purposes of complying with Section 162(m) of the Internal Revenue Code will be subject to the same level of review on plan terms, burn rate, and overhang as all other equity plan proposals
- Frequency of Say-on-Pay Votes – Where a company has adopted a policy to conduct future Say-on-Pay votes with a frequency that is less frequent than the preference of shareholders (as reflected by a majority or potentially a plurality of the votes cast in the 2011 frequency vote), ISS may recommend against all incumbent directors who are up for re-election

and environmental matters (such as political spending and workplace safety issues).

This article summarizes the policy updates for 2012 that affect executive and equity compensation matters

"Pay for Performance" Analysis

In recent years, ISS' "pay for performance" analysis has been the centerpiece of its evaluation of executive compensation programs. Historically, under this policy ISS has recommended a "withhold vote" or a vote "against" a Say-on-Pay proposal, compensation committee members, and, potentially, an equity plan proposal where there has not been a significant decrease in the chief executive officer's total direct compensation ("TDC") while, at the same time, the company's one-year and three-year total shareholder return ("TSR") were in the bottom half of its industry peer group (based on the company's four-digit global industry classification standard ("GICS") code).

ISS has revised its methodology for evaluating a company's "pay for performance" alignment to identify companies that have demonstrated strong, satisfactory, or weak alignment between CEO pay over an extended period. Under this revised approach, in the case of a company in the Russell 3000:

- ISS will measure relative and absolute "pay for performance" alignment using two tests (each of which will be equally weighted)
  - For purposes of relative alignment, ISS will review the following within an ISS-defined peer group of companies:
    - the degree of alignment between the CEO's total compensation ranking and the company's TSR ranking within the peer group over one-year and three-year periods (weighted 40%/60%) and the multiple of the CEO's total compensation relative to the peer group median; and
  - For purposes of absolute alignment, ISS will measure long-term alignment between the CEO's compensation and the company's TSR, based on trends in both over the prior five fiscal years.

For purposes of the updated policy, the peer group will be comprised of 14–24 companies that are similar to the subject company in terms of revenue, market capitalization (or, in the case of financial companies, assets), and GICS industry group. This process will be designed to select peers that are closest to the subject company, and where the subject company is close to median in revenue or asset size.

Generally, ISS will issue a "for" recommendation for a company that demonstrates a strong or satisfactory "pay for performance" alignment (in the absence of other pay-related issues). Where a company demonstrates a significant unsatisfactory "pay for performance" alignment, however (or, in the case of a non-Russell 3000 company, misaligned pay and performance are otherwise suggested), ISS will conduct a further qualitative review to come up with its vote recommendation. The factors to be analyzed will consist of:

- the ratio of performance to time-based equity awards (NOTE: ISS does not consider time-based stock options to be performance equity awards);
- the ratio of performance-based compensation to overall compensation;
- the completeness of the company's disclosure and the rigor of its 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 chief executive officer in the prior fiscal year or anomalous equity award grant practices, such as biannual awards); and
- any other factors deemed relevant.

Observations. While ISS does not anticipate that its new methodology will result in more "negative" vote recommendations than in past years, that remains to be seen. As evidenced by the fact that half of the companies with failed Say-on-Pay votes in 2011 also failed the ISS "pay for performance" analysis, this is going to continue to be an area where companies are going to need to understand their potential vulnerabilities going into their proxy cycle. Until we've been through at least one proxy season under the new methodology, companies should not assume that their experience with the policy in prior years is necessarily an indication of how they will fare in 2012.

Although most companies will welcome ISS' decision to move away from rigid reliance on GICS code-based peer groups, it is not clear whether ISS intends to make its self-constructed peer group details available in the absence of a formal client engagement. Further, even ISS' newly-refined approach to formulating peer groups is likely to be more formulaic than the sophisticated process undertaken by most companies when identifying peer companies. For example, the ISS methodology will likely still be driven largely by a company's primary industry and place less emphasis on financial measures (such as revenue growth) which are common to most peer group analyses. Consequently, companies may find that they need to engage ISS' compensation analytics services to identify its peer group and review the peer-based "pay for performance" relationship. Interestingly, ISS' potential role as both the arbiter of and an adviser on its governance and compensation policy guidelines is what has prompted the SEC to seek comment on whether proxy advisory firms should be subject to regulation.

ISS believes that the purported longer-term emphasis of the new methodology will alleviate concern about the impact of CEO turnover. Thus, except in extenuating circumstances, the presence of a new chief executive officer will not exempt the company from the "pay for performance" analysis as ISS intends to hold the compensation committee accountable when a company is compelled to significantly "overpay" for new leadership due to prior poor performance.

Finally, with the revised policy now firmly in place, it's clearly going to be a year of learning and experimentation for most companies. Based on what we know now, measuring financial and operational performance on both a relative and an absolute basis may be beneficial for many companies by extending the performance focus beyond TSR. Thus, it may help a company that is performing well operationally, even though that performance is not yet reflected in its stock price. On the other hand, the new methodology may create more risk for a company with executive compensation levels that are high relative to its peers even though the company is a high performer.

Numerous questions exist with respect to the revised policy. ISS has indicated that it plans to issue technical guidance on its peer group selection process in December. While we hope that additional guidance will be forthcoming on other aspects of the new methodology, ISS has not yet indicated whether this will be the case. Such guidance will be critical if we are to have any realistic prospect of a smooth transition to the new methodology.

Board Response to Say-on-Pay Vote

With the first year of Say-on-Pay votes now completed, investors will be looking to see how companies respond where shareholders either rejected the executive compensation program or cast a significant number of negative votes. Under SEC rules which kick in for most companies in 2012, companies will be required to disclose in their 2012 Compensation Discussion and Analysis how their compensation policies and decisions have taken into account the results of their 2011 Say-on-Pay vote.

In conjunction with this new disclosure requirement, ISS has adopted a new policy that will result in a "withhold vote" or "against" recommendation on compensation committee members (or, in some cases, the entire board of directors) and the 2012 Say-on-Pay proposal if the company's previous Say-on-Pay proposal (in this case, the 2011 proposal) received the support of less then 70% of the votes cast. In formulating this recommendation, ISS will take into account:

- The company's response to the vote, including:
  - the disclosure of the company's engagement efforts with its major institutional investors regarding the issue or issues that contributed to the low level of support;
  - the specific actions taken by the company to address the issue or issues that contributed to the low level of support; and
  - other recent compensation actions taken by the company.
- Whether the issues raised are recurring or isolated
- The company's ownership structure
- Whether the support level was less than 50% (which would warrant the highest degree of responsiveness)

Observations. While the new policy shouldn't come as a surprise – particularly to companies that experienced a failed Say-on-Pay vote in 2011, its actual application should prove interesting. While ISS initially proposed that this policy would apply where there was "significant opposition" to a Say-on-Pay proposal, its shift to essentially a "bright-line" test of 30% or more of the votes cast is likely to have

the effect of "standardizing" this level of opposition as representing a "failed" Say-on-Pay vote.

ISS notes that, based on its 2011-2012 policy survey, 72% of investors (and 40% of companies) believe that an explicit response is warranted where a company receives opposition in excess of 30% of the votes cast. The lower level of company support for this position, however, indicates that most companies believe that reliance solely on the vote outcome without a clear understanding of who cast these votes (and why) may be unwarranted.

Most importantly, it's unclear what type of actions will constitute an adequate response to the Say-on-Pay vote outcome. It appears that simply identifying the company's existing policies and practices will not suffice; ISS likely will be looking for new actions and decisions. Given the ambiguity of the underlying reasons for the vote and the challenges inherent in soliciting meaningful shareholder input, companies may have a difficult time determining in advance of an ISS review whether their response will pass muster. Further, in view of the lead time often necessary to implement program changes, it is not clear whether a commitment to adopt a new, or change an existing, policy or practice will be deemed a sufficient response to a negative vote, especially where annual Say-on-Pay votes are held.

In addition, ISS' disclosure expectations go beyond what is required by the SEC. To be sure, any company that failed its initial Say-on-Pay vote or was in the group of companies that received less than 90% support from the votes cast is well-advised to expressly address its response to its Say-on-Pay vote in its CD&A. It's unclear, however, whether a company that views its vote results as a communication, rather than a design or policy, issue will be able to draft its disclosure from this perspective without being penalized for not making significant changes to its compensation program. Similarly, where there is a fundamental disagreement between a company and ISS on a pay design or policy issue (for example, whether time-based stock options represent performance-based equity), it is not clear how the company can draft a persuasive response.

Finally, to date few (if any) companies have publicly discussed their shareholder engagement practices. The implicit expectations of the new policy are that a company should have been communicating with its major institutional shareholders about compensation matters on a regular basis, even in the absence of a failed vote or sizeable previous opposition to its compensation program, and that the company will be comfortable with disclosing private communications that it may undertake with a diverse shareholder base. (Presumably, investor engagement following a failed vote or significant opposition would be treated as a "response" to the vote outcome.) Given the practical challenges presented in directly engaging with institutional investors, the limited resources on both sides, and the number of companies that may now view this factor as a necessary precautionary step to a future negative vote outcome, this disclosure expectation has the potential to dramatically alter the current equation on when companies should engage in shareholder outreach.

Shareholder Approval for Section 162(m) Purposes

Generally, Section 162(m) of the Internal Revenue Code prohibits a public company from taking an income tax deduction for any compensation in excess of $1 million paid to its chief executive officer and its three other most highly-compensated executive officers (excluding its chief financial officer) in any taxable year. This deduction limit does not apply to so-called "performance-based compensation," which satisfies a number of enumerated conditions, including being paid pursuant to a shareholder-approved plan. Historically, ISS has generally given a "for" recommendation in the case of equity plan proposals that relate solely to Section 162(m) compliance, since the preservation of a tax deduction has been considered beneficial to a company and its shareholders.

In a sharp departure from past practice, ISS has reversed this policy and, going forward, will conduct a full equity plan analysis, including a review of the projected shareholder value transfer, burn rate (if applicable), and plan terms (such as the presence of an option repricing provision and/or a liberal "change-in-control" definition) in formulating its voting recommendation. This review will be comparable to the current level of review ISS uses when a company is seeking shareholder approval for an increase in the number of shares for an equity plan. Under the revised policy, ISS may also consider other factors, such as the "pay for performance" correlation or the presence of "problematic" pay practices as part of its analysis.

Generally, ISS will recommend "for" the plan if the proposal:

- is only to include administrative features;
- places a cap on the annual grants any one participant may receive to comply with the provisions of Section 162(m);
- adds performance goals to an existing compensation plan to comply with the provisions of Section 162(m) unless they are clearly inappropriate; or
- covers cash or cash and stock bonus plans that are submitted to shareholders for the express purpose of exempting compensation from taxes under the provisions of Section 162(m) if no increase in shares is requested.

Conversely, ISS will recommend "against" the proposal if:

- The compensation committee does not fully consist of independent outsiders (as defined by ISS); or
- The plan contains excessive "problematic" provisions (as specified in ISS' policy guidelines).

ISS will evaluate equity plan proposals on a case-by-case basis where, in addition to seeking Section 162(m) compliance, the amendment may cause the transfer of additional shareholder value to employees (for example, by requesting additional shares, extending the option term, or expanding the pool of plan participants). In this case, the shareholder value transfer will be evaluated in comparison with the company's allowable cap.

In addition, ISS will evaluate equity plan proposals on a case-by-case basis where a company is presenting the plan to shareholders for Section 162(m) compliance for the first time following the company's initial public offering of securities.

Observations. While ISS expects that it will continue to support the vast majority of Section 162(m)-motivated equity plan proposals (albeit where the company is not seeking additional shares), this policy changes closes a perceived "loophole" where potentially "problematic" plan provisions were able to escape ISS scrutiny for up to several years. Ultimately, ISS' recommendation will be based on a weighing of the overall plan (and its "problematic" provisions) against the potential loss of the income tax deduction to assess which alternative is more detrimental to shareholders.

In addition, this policy change codifies a practice that ISS has been informally applying for some time to newly-public companies. While ISS states that this change should have only a minor impact overall, we believe that it could significantly impact newly-public technology and life sciences companies whose existing employee stock plans often contain provisions that ISS considers objectionable (such as an "evergreen" feature and the ability to reprice outstanding stock options). Accordingly, newly-public companies will need to choose between removing "problematic" provisions from their equity plan when seeking to qualify for deductibility under Section 162(m) or foregoing Section 162(m) qualification. In addition, although not expressly addressed, ISS may try to hold compensation committee members accountable for "problematic" plan designs in lieu of or in addition to recommending "against" the plan proposals themselves.

Finally, this policy change aligns with the recently proposed Treasury rule related to Section 162(m) of the Internal Revenue Code, which requires newly-public companies to obtain shareholder approval before awarding certain performance-based restricted stock unit awards to their named executive officers before the end of their standard transition period for these awards to qualify as "performance-based compensation."

Board Response to Frequency Vote on Future Say-on-Pay Votes

For the 2011 proxy season, ISS consistently recommended that shareholders vote for Say-on-Pay votes be held on an annual basis. While It's not clear that this endorsement was necessary (as evidenced by the fact that 80% of the companies in the Russell 3000 saw their shareholders express a preference for annual votes), it certainly set the tone for the year.

In the rare instance where a company decides to select a frequency for future Say-on-Pay votes that differs from the shareholders' preference, ISS has adopted a new policy that will result in:

- a "withhold vote" or "against" recommendation for all incumbent director-nominees if a company conducts its Say-on-Pay vote on a less frequent basis than the frequency which received the majority of the votes cast in the company's most recent Say-on-Pay frequency proposal (the recommendation for new director-nominees will be determined on a case-by-case basis); and

- a case-by-case determination of its recommendation for all incumbent director-nominees if a company conducts its Say-on-Pay vote on a less frequent basis than the frequency which received a plurality, but not a majority, of the votes cast in the company's most recent Say-on-Pay frequency proposal, taking into account:
  - The board's rationale for selecting a frequency that is different from the frequency which received a plurality of the votes cast;
  - The company's ownership structure and vote results;
  - ISS' analysis of the company's executive compensation program and whether there are compensation concerns or a history of problematic compensation practices; and
  - The previous year's support level on the company's Say-on-Pay proposal.

Observations. ISS characterizes majority shareholder support for a specific Say-on-Pay frequency as a "mandate" to the board of directors. Accordingly, it views an unwillingness to implement the frequency preferred by shareholders as tantamount to a board of directors' failure to act on a shareholder proposal receiving a majority of the votes outstanding for one year, or a majority of the votes cast twice in the last three years – a long-standing ISS policy.

To date, we have only identified two companies that have announced a decision to hold future Say-on-Pay votes with a frequency that differs from the preference expressed by its shareholders (in each case, a decision to hold triennial, rather than annual, votes). Even in situations where only a plurality of the votes cast favored annual Say-on-Pay votes, almost without exception companies have chosen to abide by that preference. Consequently, we do not expect that this policy will have widespread effect in 2012.

Burn Rate Policy

Each year, ISS updates its "burn rate" tables and allowable limits for the upcoming proxy season. This year's updated tables will be published in December. "Burn rate" is measured using the total number of equity grants (stock and options) awarded in a given year and is expressed as a percentage of the number of common shares outstanding. These tables set the acceptable burn rate levels (based on one standard deviation above the industry mean) using global industry classification standard ("GICS") codes.

Currently, ISS will recommend a vote "against" an equity plan proposal if the company's average three-year burn rate exceeds the greater of:

- the mean plus one standard deviation of the company's GICS peer group segmented on the basis of whether or not it is in the Russell 3000; or
- two percent of the company's weighted common shares outstanding.

In addition, If a company grants both full value awards and stock options, ISS applies a premium or "multiplier" to the full value awards for the past three fiscal years to equate them economically with stock options.

Updated burn rate tables for 2012 won't be available until December.

Implications of Updated Policies

While this year's executive compensation policy updates are significantly more limited than in prior years, they potentially could have a far more sweeping impact. For most companies, the key question in 2012 will be whether the changes to ISS" pay for performance" analysis affect its review of their executive compensation program. Given that almost all of the companies that failed their Say-on-Pay vote (or, for that matter, received significant opposition to their Say-on-Pay proposal) also received a negative vote recommendation from ISS, and a majority of these negative recommendations resulted from an ISS-determined "pay for performance" disconnect, this will be the most problematic concern going into the next proxy season.

Companies with unusual compensation structures or controversial pay policies or practices should use their Compensation Discussion and Analysis as a platform to explain and justify their compensation policies (and related decisions) to ensure that ISS has access to appropriate information with which to formulate its 2012 voting recommendations.

To obtain a copy of the ISS "US Corporate Governance Policy – 2012 Updates," click here

About Compensia

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management.

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