ISS Issues 2014 Policy Updates

Institutional Shareholder Services, the prominent corporate governance advisory services firm, has updated its U.S. corporate governance benchmark policy guidelines for 2014. Unlike prior years, this year's updates cover only a handful of items, including two changes to the "pay for performance" methodology that ISS uses to evaluate the link between corporate financial performance and executive pay (which is a key consideration in how ISS formulates its voting recommendation on a company's Say-on-Pay proposal). These changes will be reflected in the corporate governance and executive compensation policies that ISS will use to determine its voting recommendations for its proxy advisory clients during the upcoming 2014 proxy season.

The ISS' Benchmark U.S. Corporate Governance Policies updates are available at the following link »

The updated policies are effective for annual shareholder meetings held on or after February 1, 2014.

Significance of Policies

As a long-time advisor to the institutional investor community, ISS regularly publishes annual updates to its standards on good corporate governance and executive compensation policies and practices. The standards for U.S.-based companies, which are contained in a policy statement published in advance of each year's proxy season, 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, these updates actually encompass a broad range of social and environmental matters as well (such as political spending and workplace safety issues).

This article summarizes the policy updates for 2014 that affect executive and equity compensation matters.

Three Things Technology and Life Sciences Companies Should Know About the ISS Policy Updates

- **Evaluating Say-on-Pay Proposals** – ISS has made a significant refinement to the quantitative assessment portion of its "pay-for-performance" methodology, eliminating the one-year relative comparison of a company's CEO total compensation ranking and total shareholder return ranking against an ISS-constructed peer group. Going forward, ISS will conduct this relative comparison over a three-year measurement period only.
- **Consideration of "Realizable Pay"** – ISS has expanded the group of companies for which it will consider a CEO's "realizable pay" compared to his or her "grant pay" (as reported in a company's Summary Compensation Table) as part of the qualitative assessment portion of its "pay for performance" methodology to include all of the companies in the S&P 1500. Previously, ISS made this realizable pay/grant pay comparison for S&P 500 companies only.
- **Board Responsiveness to Majority-Approved Shareholder Proposals** – On a case-by-case basis, ISS will recommend a vote against an individual director, committee members, or an entire board of directors as appropriate if the board of directors has failed to act on a shareholder proposal that received the support of a majority of the votes cast on the proposal in the previous year and has not provided an adequate rationale for its action.

Evaluating a Say-on-Pay Proposal

ISS continues to refine its methodology for analyzing an executive compensation program in the context of the shareholder advisory vote on executive compensation ("Say-on-Pay") proposal. As originally implemented for the 2012 proxy season, ISS conducts a two-step analysis to identify strong or satisfactory alignment between a company's executive compensation program and financial performance over a sustained period.

This analysis starts with a quantitative assessment of (i) the relative degree of alignment between the company's total shareholder return ("TSR") ranking and the chief executive officer's total compensation ranking within an ISS-constructed group of peer companies, as measured over one-year and three-year periods, and (ii) the multiple of the chief executive officer's total compensation relative to the peer group median. It also includes a review of the absolute alignment between the trend in the chief executive officer' pay and the company's TSR over the prior five fiscal years.

The analysis then shifts to an assessment of the following qualitative factors, if they are deemed relevant to determining how various pay components may work to encourage or undermine long-term value creation and alignment with shareholder interests:

- The ratio of performance-based to time-based equity awards;
- The overall ratio of performance-based compensation;
- The thoroughness of the company's disclosure and rigor of performance goals;
- The company's peer group benchmarking practices;
- The actual results of financial/operational measures (such as growth in revenue, profit, cash flow, etc.) both absolute and relative to peers;
- Special circumstances related to, for example, a new chief executive officer in the prior fiscal year or anomalous equity grant practices (such as bi-annual awards);
- Realizable pay compared to grant pay; and
- Any other factors deemed relevant.

If the quantitative "screen" demonstrates a significant unsatisfactory long-term pay-for-performance alignment, this qualitative review tends to be more intensive than in situations where ISS finds a satisfactory alignment.

Elimination of One-Year Relative TSR/CEO Total Compensation Comparison

After two years of comparing a company's TSR ranking and CEO total compensation ranking against an ISS-constructed peer group over both one-year and three-year periods, ISS has decided to eliminate the one-year comparison. Beginning with the 2014 proxy season, ISS will conduct a single, annualized relative degree of alignment comparison for the most recent three-year measurement period only. If three years of compensation data are not available, ISS will use the number of full fiscal years that the company's securities have been publicly-traded and pay data for the CEO has been disclosed.

Observations. This revision should benefit many companies by eliminating from the quantitative "screen" the most recent fiscal year as a separate measurement period. As some companies discovered, where this year produced significantly TSR volatility, it could have an outsize effect on the overall analysis.

Historically, the one-year and three-year performance periods were weighted 60%/40% in favor of the three-year assessment. As acknowledged by ISS, however, because the most recent year is included in both measurement periods, this led to the most recent year being most heavily weighted. Under the new approach, each year of TSR will be weighted equally and calculated to produce the annualized TSR for the measurement period. ISS expects that this will provide a smoother performance measure that does not over-emphasize any particular year during the measurement period. And as ISS notes, if there are relevant considerations between pay and performance in any given year, this will be addressed as part of its assessment of qualitative factors, as applicable.

On the other hand, this change may hurt companies that have reduced the total direct compensation opportunity of their CEO in their most recently-completed fiscal year. In this situation, a company was likely to score well on the one-year relative degree of alignment test. With this measurement period no longer part of the assessment, companies have lost the ability to improve the results of this test (as part of an overall effort to enhance the results of the quantitative "screen") by decreasing their CEO's pay before the end of the current fiscal year.

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Increase in Number of Companies for Which Realizable Pay Will Be Considered

As part of last year's policy updates, ISS added "realizable pay" as a factor to be considered as part of its qualitative assessment. For this purpose, "realizable pay" consists of the sum of the relevant cash and equity-based grants and awards made to a company's CEO during the performance period being measured, based on equity award values for awards that are actually earned, or target award values for ongoing awards, calculated using the stock price at the end of the performance period. Notably, stock options and stock appreciation rights are revalued using the remaining award term and updated assumptions, as of the performance period, using a Black-Scholes option pricing model.

While reflected in every ISS report, where a "large cap" company was deemed to have a pay-for-performance "disconnect" (based on ISS' quantitative "screen") ISS would attach more significance to the comparison of a CEO's realizable pay to his or her "grant pay" (as reported in the Summary Compensation Table) as part of its qualitative assessment.

For the 2014 proxy season, ISS has now expanded the group of companies for which this factor will be considered to encompass the S&P 1500. The S&P 1500 (or, as it is sometimes known, the S&P Composite 1500 Index) includes the companies in the Standard &Poor's 500 (the 500 largest companies having common stock listed on the NYSE or NASDAQ based on market capitalization), the S&P MidCap 400 Index (which currently includes companies with market capitalizations ranging from approximately $750 million to $3.3 billion), and the S&P Small-Cap 600 Index ((which currently includes companies with market capitalizations below approximately $750 million).

Observations. While it is unclear how the inclusion of "realizable pay" as a factor in its qualitative assessment ultimately affected ISS' voting recommendations on Say-on-Pay proposals during the 2013 proxy season, ISS has indicated that of the companies that received a "high concern" designation as a result of its quantitative "screen," ultimately only half (actually 51%) of these companies received an unfavorable vote recommendation on their Say-on-Pay proposals. Mid cap and small cap companies should be aware that, going forward, the realizable pay of their chief executive officer could come under scrutiny as part of the review of their executive compensation programs.

Board Response to Majority-Supported Shareholder Proposal

In 2013, ISS revised its policy for evaluating a board of directors' responsiveness to a majority-approved shareholder proposal to cover proposals that received a majority of the votes cast rather than a majority of the shares outstanding in the prior year. Beginning with the 2014 proxy season, where the response is deemed to be insufficient, ISS may recommend an "against" or "withhold" vote for individual directors, committee members, or the entire board of directors, as appropriate.

While ISS has made no actual changes to this policy, it has clarified that its recommendations on the re-election of directors with respect to majority-supported shareholder proposals will be made on a "fact-specific, case-by-case basis" (rather than automatically "against" re-election). In formulating its recommendation, ISS will consider several factors as expressly enumerated in the policy.

The key factor in the analysis will be "the board's rationale as provided in the proxy statement for the level of implementation" of the proposal. Other factors that will be considered include:

- Disclosed outreach efforts by the board of directors to shareholders in the wake of the vote;
- The subject matter of the proposal;
- The level of support for and opposition to the proposal in past annual shareholder meetings;
- Actions taken by the board of directors in response to the majority vote and its engagement with shareholders; and
- The continuation of the underlying issue as a voting item on the ballot (as either shareholder or management proposals).

Observations. For several years, institutional investors have expressed frustration when a company has failed to implement – or even respond – to a shareholder proposal that has received sustained support. This frustration has prompted ISS to act, which has now culminated in a policy, beginning in the 2014 proxy season, where, if a board of directors takes action that is less than full implementation of the proposal, it will be expected to provide a rationale justifying this decision. The shift to defining

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"majority support" on the basis of the votes cast at the previous year's annual meeting (rather than the total number of shares outstanding as under the previous policy) will make it easier for a proposal to receive majority support – thereby triggering the policy. It is likely that board declassification and other corporate governance-related proposals will be the first group of proposals that garner attention under this policy.

This expectation of board responsiveness is consistent with ISS' presumption of robust shareholder engagement where a Say-on-Pay proposal is either defeated or receives significant opposition from shareholders. Consequently, large companies (which receive over 85% of all shareholder proposals) will be under increasing pressure to develop and maintain an effective investor engagement process to handle their corporate governance and executive compensation-related issues. It also means that disclosure of these outreach efforts in the proxy statement will become a more important item, at least for ISS if not for shareholders generally.

Consultation Period for Longer-Term Changes

In conjunction with its policy updates, ISS has also established a new "Benchmark Policy Consultation" web site and consultation period for potential policy changes beyond the 2014 proxy season. As explained in its announcement, ISS is using this website as a means to gather comments and feedback on its policies for U.S.-based companies in the areas of director tenure and independence, independent Board chair shareholder proposals, and equity-based compensation plans. Any changes in these policies would not be effective until the 2015 proxy season or later.

This new website represents a significant departure from ISS' current approach of soliciting feedback for possible policy changes annually each fall. ISS indicates that its goal is to shift its process from a seasonal to a continual focus on policy development.

Possible New Approach for Evaluating Equity Compensation Plans

As part of this shift to a new consultation website, ISS is considering an alternative to its current U.S. benchmark policy regarding equity compensation plans for 2015 and beyond. Generally, this alternative would involve adopting a "balanced scorecard" approach that allows the weighting of multiple factors in a "holistic" evaluation of the plan. As ISS suggests, under such an approach historical equity awards might elevate a company's burn rate and share value transfer score, although these cost concerns might be counterbalanced by a relatively small new share request and a declining burn rate.

What's Next?

As in past years, it is expected that ISS will issue a series of "Frequently Asked Questions" later this month that contain additional guidance related to its new policies. In addition, ISS will be publishing updated "burn rates" sometime this month.

Need Assistance?

Compensia has significant experience in helping companies understand and address ISS' corporate governance and executive compensation policies. If you have any questions on the topics covered in this Thoughtful Pay Alert or would like assistance is assessing how the policies are likely to affect your executive compensation program, please feel free to contact us. ■

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About Compensia

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

Silicon Valley

1731 Technology Drive
Suite 810
San Jose, CA 95110
408.876.4025

Timothy J. Sparks, President
tsparks@compensia.com
408.876.4024

Thomas G. Brown
tbrown@compensia.com
408.876.4023

Susan Gellen
sgellen@compensia.com
408.907.4302

Tom LaWer
tlawer@compensia.com
408.907.4309

San Francisco

1550 Bryant Street
Suite 740
San Francisco, California 94103
415.462.2990

Mark H. Edwards, Chairman
medwards@compensia.com
415.462.2985

Mark A. Borges
mborges@compensia.com
415.462.2995

Southern California

Ralph Barry
rbarry@compensia.com
858.603.2288

Mathew T. Quarles
mquarles@compensia.com
323.919.7338