

ISS Previews 2012 Policy Updates

Institutional Shareholder Services, the prominent corporate governance advisory services firm, has published a preview of certain of its likely corporate governance policies for U.S. companies for 2012. Although it is not a comprehensive summary of all of the policy changes that may apply in 2012, the preview highlights several important items for technology and life sciences companies, including board of directors' responses to the initial shareholder advisory votes on executive compensation required under the Dodd-Frank Wall Street Reform and Consumer Protection Act and how ISS will evaluate companies' executive compensation policies and practices.

ISS is inviting companies, shareholders, and other market participants to comment on the proposed policy updates before it finalizes the policies for next year. Time to respond is limited, however, as comments must be received by October 31, 2011. ISS plans to issue its policy updates for 2012 during the week of November 14, 2011.

ISS' updated policies will be effective for shareholder meetings held after February 1, 2012.

Background

As a long-time advisor to the institutional investor community, ISS has established itself as a 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 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.

On October 18, 2011, as a prelude to the publication of its policy updates for 2012, ISS announced that it was soliciting comments from companies, shareholders, and other market participants on a number of the policy updates under consideration. While the proposed updates do not reflect all of the policies that will apply during the 2012 proxy sea-

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

- ▶ "Pay for Performance" Analysis – ISS is proposing to significantly revamp 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 causal or mitigating factors for purposes of making its voting recommendations on compensation-related proposals
- ▶ Say-on-Pay – Where a company has received "significant opposition" to its 2011 Say-on-Pay proposal (that is, the Say-on-Pay vote failed or otherwise received a significant number of negative votes), ISS will closely evaluate the company's response to the vote and may recommend "against" the current Say-on-Pay proposal and compensation committee members if the response is deemed inadequate. ISS is seeking feedback on whether opposition of 30% or more should be considered "significant"
- ▶ 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 results of the 2011 frequency vote, ISS may recommend against all incumbent directors who are up for reelection
- ▶ 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

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son, they represent many of the more significant issues that arose this year as a result of the initial shareholder advisory votes on executive compensation that were required of public companies.

Here are the key proposals affecting executive compensation matters for U.S. companies.

“Pay for Performance” Analysis

In recent years, ISS’ “pay for performance” policy has been the centerpiece of its analysis 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 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 is proposing to revise 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 and corporate performance over an extended period. Under its revised approach:

- 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 a group of ISS-defined peer 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 revised policy, the comparator peer group will be comprised of 14 - 24 companies that are similar to the subject company in terms of revenue, market capitalization (based on the company’s life cycle maturity phase), and GICS industry group.

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 weak “pay for performance” alignment, however, ISS will conduct a further qualitative review to come up with its vote recommendation. The factors to be considered will consist of:

- the ratio of performance to time-based equity awards and the overall ratio of performance-based compensation;
- the “robustness” 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 any non-standard equity grant practices, such as biannual awards); and
- any other relevant factors.

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” policy, 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

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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 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 roles 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.

Finally, if the policy is adopted as proposed, 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 proposed revisions to this policy. Assuming that ISS proceeds to adopt the policy as proposed, we believe that it will need to issue definitive guidance responding to these questions and other open issues before the end of the year to have any 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 in the books, investors will be looking to see how companies respond where investors either rejected the executive compensation program or cast a significant number of negative votes. Under SEC rules, companies are 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 vote.

In conjunction with this new disclosure requirement, ISS is planning to adopt a policy that will result in a "with-

hold 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 2011 Say-on-Pay proposal received significant opposition from the votes cast. In formulating its recommendation, ISS intends to take into account:

- The level of opposition to the proposal;
- The company's ownership structure;
- The disclosure (if any) of the company's engagement efforts with its major institutional investors regarding the compensation issue or issues;
- The company's response to the vote;
- The specific actions taken by the company to address the issue or issues that appear to have caused the significant level of "against" votes;
- Other recent compensation actions taken by the company; and
- ISS' current analysis of the company's executive compensation program and whether any prior areas of concern are recurring or one-time.

As expected, a higher level of scrutiny will be given to companies where the executive compensation program received less than 50% support from the votes cast. In addition, the recurrence of a previously-identified "poor pay practice" or a newly-identified compensation concern, may, depending on the severity, result in an "against" recommendation on a company's Say-on-Pay proposal and a "withhold vote" or "against" recommendation on compensation committee members.

Observations. While the proposed policy shouldn't come as a surprise – particularly to companies that experienced a failed Say-on-Pay vote in 2011, its actual application may prove problematic. For example, it's not clear what constitutes "significant opposition" to a Say-on-Pay proposal, or whether this standard will be applied uniformly to all companies or vary based on individual circumstances. 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, suggesting that this may become the de facto line of demarcation. The lower level of company support for this position, however, indicates that most companies believe that reliance solely on the vote outcome

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without a clear understanding of who cast these votes (and why) may be unwarranted. In addition, it appears unlikely that ISS would adhere to a “bright line” test if it believes that a company’s compensation actions or existing policies and practices raise concerns under its other policies.

It’s also 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 difficulty that many companies may experience in soliciting meaningful input from their major shareholders, however, companies may face formidable challenges in 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 conducted.

In addition, ISS’ disclosure expectations go beyond what is required by the SEC. To be sure, a 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.

Further, to date few (if any) companies have publicly discussed their shareholder engagement practices. The implicit expectations of the proposed 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 fol-

lowing 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.

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

During 2011, 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 proxy season. To date, in almost every instance where a company has disclosed its decision as to the frequency of future Say-on-Pay votes, it has chosen to abide by its shareholders’ preference.

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 is planning to adopt a policy that would 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; and
- a case-by-case determination of its recommendation 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 company’s rationale for choosing a frequency that is different from the frequency which received a plurality of the votes cast;
 - ▶ The company’s ownership structure;

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- ▶ ISS' analysis of the company's executive compensation and whether there are compensation concerns or a history of problematic compensation practices;
- ▶ The previous year's support level on the company's Say-on-Pay proposal; and
- ▶ The difference between the frequency adopted and the frequency supported by shareholders

Observations. This policy position was also not unexpected. As ISS acknowledges, this policy is similar to its policy to issue a "withhold vote" or "against" recommendation for directors when the board of directors fails 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.

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. In addition, we note that, where the results of the frequency vote have been close, most companies have opted to proceed with a Say-on-Pay vote in 2012 and, at the same time, conduct another frequency vote – a practice that is permitted under the SEC's rules.

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 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 is proposing to reverse this policy and 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). 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.

Observations. This policy change essentially codifies a practice that ISS has been informally applying for some time. While ISS states that the proposed 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.

What's to Come

ISS is soliciting comments on the proposed policy updates until October 31, 2011. ISS has indicated that it plans to issue its policy updates for 2012 during the week of November 14, 2011. As in prior years, the policy updates will go into effect at the beginning of February of the following year; in this case, February 1, 2012.

To access the ISS portal to its proposed policy updates, [click here](#)

ISS Previews 2012 Policy Updates (continued)**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 in assessing how the policies are likely to affect your executive compensation program, please feel free to contact us.

About Compensia

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