

Institutional Shareholder Services (ISS)

The Basics

According to its website, ISS is the leading provider of corporate governance research, covering more than 40,000 shareholder meetings in over 100 developed and emerging markets worldwide. More than 1,700 clients (primarily large institutional investors) rely on ISS' vote recommendations to make informed decisions. Most ISS clients do not have the resources to meet certain fiduciary duties, so they outsource that research and recommendation role to ISS. ISS also provides corporate advisory services aimed at ensuring that companies comply with its internal standards with respect to equity plan proposals. They also provide Governance Risk Indicators (GRId) on companies, a governance rating methodology designed to reflect current best practices. ISS' GRId analysis includes 28 compensation-related factors.

How influential is ISS?

ISS's clout has increased in the Say on Pay environment. Nonetheless, its direct impact on vote outcomes is mixed. ISS issued "AGAINST" recommendations on Say on Pay proposals for approximately 260 component companies of the Russell 3000 index. Of these 260 companies, only 34 companies failed to receive majority support for their say on pay proposals. However, an ISS negative vote recommendation clearly reduced the level of support for a company's Say on Pay proposals. According to the Center on Executive Compensation, a negative vote recommendation on a management proposal can reduce the support of institutional investors by up to 20%.¹ Similarly, a recent academic study found that the marginal impact of an ISS recommendation ranged from 17.6% to 21.4%.² Over time, repeated negative vote recommendations by ISS may ultimately result in a company failing Say on Pay.

The Details

Given ISS' influence over proxy voting outcomes, companies should be aware of ISS' Policy Guidelines, particularly with respect to its evaluation of executive compensation issues. Such issues are increasingly an area of focus for shareholders and the media since the Dodd-Frank Wall Street Reform and Consumer Protection Act implemented the requirement of an advisory vote on executive compensation at annual shareholder meetings.

ISS' Policy Guidelines on Say on Pay

ISS' Policy Guidelines provide that when a company maintains "problematic pay practices," ISS will generally recommend a vote:

- **AGAINST** management "say on pay" proposals;
- **AGAINST/WITHHOLD** on compensation committee members (or in rare cases where the full board is deemed responsible, all directors including the CEO):
 - In egregious situations;
 - When no SOP item is on the ballot; or
 - When the board has failed to respond to concerns raised in prior Say on Pay evaluations; and/or

¹ "A Call for Change in the Proxy Advisory Industry Status Quo". Center on Executive Compensation January 2011.

² Stephen Choi, Jill E. Fisch, and Marcel Kahan. "The Power of Proxy Advisors: Myth or Reality". University of Pennsylvania Law School Institute for Law and Economic. Research Paper no. 10-24.

- **AGAINST** an equity incentive plan proposal if excessive non-performance-based equity awards are the major contributors to a pay-for-performance misalignment, or if the potential Shareholder Value Transfer (SVT) is too high compared to ISS industry-specific guidelines.

What are the primary reasons for negative vote recommendations issued by ISS on Say on Pay proposals?

The primary reason ISS recommended against Say on Pay proposals is that it finds there is a CEO “pay-for-performance disconnect.” ISS changed its methodology for evaluating CEO pay for performance for the 2012 proxy season. This methodology is discussed in the Meridian article entitled “Navigating Say on Pay.”

ISS also recommended against a Say on Pay proposal if the company has engaged in what ISS deems to be “problematic pay practices.” ISS’ Policy Guidelines identify a select number of these pay practices that are considered “most egregious.” These egregious pay practices “carry significant weight” in ISS’ assessment of a company’s pay programs and may result in an adverse vote recommendation. ISS policies indicate that the presence of an egregious pay practice, standing alone, is sufficiently problematic to warrant withhold vote on compensation committee members or against vote on Say on Pay proposals **in most circumstances**. However, ISS notes that its vote recommendation will continue to be made on a **case-by-case basis** and that egregious pay practices along with other problematic pay practices may ultimately result in negative vote recommendations based on consideration of a company’s overall pay programs and past practices.

What are ISS’ Egregious Pay Practices?

ISS has stated that it considers the following to be “egregious pay practices”:

- Repricing or replacing of underwater stock options or SARS without prior shareholder approval (including cash buyouts and voluntary surrender of underwater options);
- Excessive perquisites or tax gross-ups, including any gross-up related to a secular trust or restricted stock vesting;
- New or extended agreement that provides for:
 - Change-in-control (“CIC”) payments exceeding three times base salary and average, target or the most recent bonus;
 - CIC severance payments without involuntary job loss or substantial diminution of duties (“single” or “modified single” triggers); or
 - CIC payments with excise tax gross-ups (including “modified” gross-ups).

What are ISS’ Problematic Pay Practices?

ISS’ Frequently Asked Questions document provides the full list of pay practices that are considered problematic and may result in a withhold or against recommendation on a case-by-case basis. In particular, ISS identifies the following pay practices as “particularly contrary” to a performance-based pay philosophy:

- Egregious employment contracts (e.g., contracts containing multiyear guarantees for salary increases, non-performance-based bonuses and equity compensation).
- New CEO with overly generous new-hire package (e.g., excessive “make whole” provisions without sufficient rationale).
- Abnormally large bonus payouts without justifiable performance linkage or proper disclosure. Includes performance metrics that are changed, canceled or replaced during the performance period without adequate explanation of the action and the link to performance.
- Egregious pension/SERP (supplemental executive retirement plan) payouts.

- Excessive Perquisites.
- Excessive severance and/or CIC provisions.
- Excessive reimbursement of income taxes on executive perquisites or other payments.
- Dividends or dividend equivalents paid on unvested (unearned) performance shares or units.
- Executives using company stock in hedging activities, such as “cashless” collars, forward sales, equity swaps or other similar arrangements.
- Internal pay disparity (e.g., “excessive” differential between CEO total pay and that of next highest-paid named executive officer).
- Other pay practices that may be deemed problematic in a given circumstance but are not covered in the above categories.

As part of its holistic review of a company’s compensation programs, ISS will consider the presence of any of the foregoing problematic pay practices in developing its vote recommendations. Standing alone, a single problematic pay practice is unlikely to result in a negative vote recommendation. However, the greater the number of problematic pay practices, the higher the likelihood that ISS will issue a negative vote recommendation on a company’s compensation committee members and/or Say on Pay proposal.

Equity Plan Proposals

Generally, ISS will recommend a vote **FOR** a new equity compensation plan proposal (or a request for additional shares under an existing equity compensation plan) if each of the following five ISS governance policies is met:

- **Shareholder Valuation Transfer Cost Policy**—A company’s equity plan will satisfy ISS’ Shareholder Valuation Transfer (“SVT”) cost policy if the cost of the equity plan does not exceed the company-specific ISS cost cap, as determined under ISS’ proprietary SVT model.
- **CEO Pay for Performance Policy**—ISS’ Pay-for-Performance Policy is applicable to a company if (i) a significant portion of the CEO’s misaligned pay is attributed to non-performance-based equity awards; and (ii) the CEO is a participant in the equity plan.

If the Pay-for-Performance Policy is applicable to a company, then ISS will evaluate the following factors to determine if the company has complied with its Pay-for-Performance Policy:

- Magnitude of pay misalignment (ISS will use its new and more complex pay-for-performance methodology to determine if a pay misalignment is present);
 - Contribution of non-performance-based equity grants to overall pay; and
 - The proportion of equity awards granted in the last three fiscal years concentrated at the named executive officer level.
- **Burn Rate Policy**—A company will meet ISS’ Burn Rate Policy if the company’s three-year average burn rate does **not**:
 - Exceed the industry mean plus one standard deviation; **or**
 - Exceed 2% of the company’s fiscal year-end weighted average common shares outstanding.
 - **Repricing Policy**—A company will satisfy ISS’ Repricing Policy if the company’s equity plan prohibits the amendment of outstanding underwater stock options/SARs awards to reduce the exercise price of such stock options/SARs or the cancellation of outstanding underwater stock options/SARs in exchange for other awards or stock options/SARs with an exercise price that is less than the exercise price of the

cancelled stock options/SARs without prior stockholder approval. [**Note:** ISS policy considers the cash buyout of underwater options/SARs to be a form of repricing; however, ISS' informal position is that the absence of a prohibition on cash buyouts of underwater options/SARS will not in itself cause ISS to recommend an AGAINST vote on a company's equity plan proposal. In contrast, ISS' on-line SVT modeling tool indicates that providing for cash buyout of underwater options triggers an automatic AGAINST recommendation from ISS.]

- **Liberal Change-in-Control Definition Policy**—A company will satisfy ISS' Liberal Change-in-Control Definition policy if the company's equity plan does not include a change-in-control definition which could trigger payments to executives without the consummation of the underlying change-in-control event.

Governance Risk Indicators (“GRId”)

In 2010, ISS created a new method for assessing corporate governance, which it called the Governance Risk Indicators or “GRId.” The areas of governance subject to GRId assessment are a company's audit, board, compensation and shareholder rights practices. Each overall governance area is scored “low,” “medium” or “high” concern.

ISS offers companies the opportunity to view their GRId indicators and verify the data underlying its GRId scores. Comments are automatically submitted to ISS' GRId team and replies to the inquiry sent back to the company within five business days. In addition, some companies have elected to address an issue in the proxy statement in order to increase their GRId score.