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Meridian Client Update

ISS Releases its 2011-2012 Policy Survey Results

Each year, ISS seeks feedback on emerging corporate governance and executive compensation issues as part of its annual policy formulation process. ISS seeks input from its institutional investor clients, public companies ("issuers"), and the advisory community. On September 26, 2011, ISS released the results of its 2011-2012 Policy Survey. Below are the key findings of the survey:

- **Pay levels relative to peers and a company performance's trend are relevant for both investor and issuer respondents when determining pay for performance alignment**. A majority of both investors (60%) and companies (61%) identified executive compensation as one of the top three governance topics for the coming year, similar to last year's results.

  When determining whether executive pay is aligned with company performance, an overwhelming majority of investor respondents considered both **pay that is significantly higher than peer pay levels and pay levels that have increased disproportionately to the company's performance** trend to be "very relevant" (62% and 88%, respectively). On the other hand, most companies considered both of these factors to be "somewhat relevant" (51% and 48%, respectively).

Meridian Comment: *ISS may be considering a more holistic approach to evaluating pay-for-performance than its current pay-for-performance policy, which generally will apply to a company if the following conditions are present:*

- *A company's relative one- and three-year total shareholder returns are below the median of its four-digit Global Industry Classification Standard (GICS) Industry Group; and*
- *The CEO has served for at least two years in that role and pay did not decline significantly year over year.*

If this threshold test is met, ISS currently considers a variety of factors to determine whether a pay-for-performance disconnect exists. The Policy Survey results may prompt ISS to give greater weight to circumstances where pay is significantly higher than peer pay levels in evaluating whether a pay-for-performance disconnect exists.

- **Investor and issuer respondents diverge on opposition levels to a say-on-pay vote that should trigger a board response to improve pay practices**. Investors and companies had different views on when boards should respond to shareholder opposition to say-on-pay votes. The most commonly cited level of opposition on a say-on-pay proposal that should trigger an explicit response from the board to improve pay practices is "more than 20%" for investors (36%) and "more than 50%" for companies (48%). However, on a cumulative basis, 48% of investor respondents and 52% of

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companies indicate that an explicit response from the board regarding improvement to pay practices should be made at opposition levels at "more than 20%" and "more than 40%," respectively.

> **Meridian Comment:** *It is likely that ISS will develop a policy for 2012 to issue adverse vote recommendations (likely recommending against board members) in the event that a company's board does not adequately respond to investor concerns regarding its pay practices when opposition levels exceed 20%-30%.*

- **Discretionary annual bonus awards can sometimes be problematic: investor and issuer respondents agree.** A majority of investors (57%) and 46% of companies agreed that discretionary annual bonus awards (i.e., those not based on attainment of pre-set goals) are sometimes problematic, if the awards are not aligned with company performance.

- **Less appetite from investor respondents in taking into account positive factors to mitigate cost of an equity plan.** Responses from investors and companies varied greatly as to whether certain positive factors mitigate circumstances where an equity plan's shareholder value transfer (SVT) cost is excessive relative to peers. The mitigating factors that ISS' survey identified included: above median long-term shareholder return, low average burn rate relative to peers, double-trigger change in control equity vesting, reasonable plan duration and robust vesting requirements. Most investors were reluctant to indicate that any of those factors would "very much" mitigate an equity plan's "excessive" cost. For certain factors, e.g., above median long-term shareholder return (72%) and low average burn rate relative to peers (59%), the majority of companies indicated that these factors should "very much" be taken into account to mitigate the perceived cost of the plan.

- **Investor respondents support consideration of factors other than excessive SVT cost as weighing against approval of an equity plan**. Investor respondents support consideration of factors other than excessive SVT cost as weighing against approval of an equity plan. Where SVT cost is not excessive, a majority of investor respondents indicated that certain negative factors should weigh against approval of an equity plan (e.g., a liberal CIC definition with automatic award vesting; excessive potential share dilution relative to peers; prolonged poor financial performance; prolonged poor shareholder returns). Of all of these factors, a vast majority of investor respondents (73%) cited prolonged poor financial performance and prolonged poor shareholder returns as negative factors that should weigh against approval of the plan.

- **"Single-trigger" equity vesting in the context of equity plans elicits vastly differing views from issuer and investor respondents.** An overwhelming majority of investors (79%) do not consider automatic accelerated vesting of outstanding grants upon a change in control or accelerated vesting at the board's discretion after a change in control (71%) to be appropriate. A significant majority of companies disagrees, and consider both scenarios appropriate. However, both companies and investors agree that accelerated vesting in certain circumstances after a change in control (e.g., if awards are not converted or replaced by a surviving entity) is appropriate.

> **Meridian Comment:** *The results from this inquiry indicate that ISS may develop a policy for 2012 to recommend against an equity plan in the event the plan provides that upon a change in control outstanding awards are immediately vested. Thus far, ISS is not as concerned about existing grants with single trigger vesting, but prefers all future grants have a double trigger design.*

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- **Pressure from investor respondents for independent board leadership remains strong.** 70% of investors indicated that companies should adopt a policy of appointing an independent chair *after* the current (combined) CEO/chair leaves the position. A substantial majority of companies disagree, with 73% indicating that companies should not commit themselves to an independent chair.

ISS expects to release a draft of its Policy Updates for an open comment period in October 2011. ISS's Final Policy Updates are expected to be issued in November 2011. These Final Policy Updates will be applicable for meetings on or after February 1, 2012.

Council of Institutional Investors White Paper Identifies Pay-For-Performance Concerns Motivated "Say-on-Pay" Dissenting Votes

The Council of Institutional Investors (CII) released a report today that addresses how institutional investors approached "say on pay" votes during the spring 2011 U.S. proxy season. As expected, most investors said "pay-for-performance" disconnects were a major reason for voting against corporate compensation practices.

Investors gave various reasons for opposing corporate pay practices, but the factors most frequently cited were:

- A disconnect between pay and performance (92%)
- Poor pay practices (57%).
- Poor disclosure (35%).
- Inappropriately high level of compensation for the company's size, industry, and performance (16%).

Meridian Comment: *Not surprisingly, both the CII survey and the ISS survey found that institutional shareholders are most concerned about the presence of a pay for performance disconnect.*

The report's other findings include:

- Investors were extremely thoughtful about evaluating executive compensation for "say on pay" votes.
- Due to resource constraints, investors used proxy advisory firms' analyses to varying degrees.
- Investors considered multiple factors as well as inputs from various sources in determining their say-on-pay votes.
- Investors evaluated performance and pay over multiple years, and focused primarily on total absolute shareholder return (TSR) over one-, three- and five-year periods.
- Investors spent the most time and resources analyzing pay at "outlier" companies: those with large disconnects between pay and performance, high overall pay and/or low TSR in comparison to their industry or peers.
- Investors focused on CEO pay, rather than the pay of other NEOs and on the overall "reasonableness" of the level of compensation in view of the company's size, industry and performance.

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- Investors mostly regarded the "say on pay" vote as an opportunity to voice their concerns about a particular pay program, not a referendum on directors' oversight of compensation.

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The ***Client Update*** is prepared by Meridian Compensation Partners' Technical Team led by Donald Kalfen. Questions regarding this Client Update or executive compensation technical issues may be directed to Donald Kalfen at 847-235-3605 or dkalfen@meridiancp.com.

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