

Meridian Client Update

ISS Releases 2012 Draft Policy Updates for External Comment

On October 18, ISS released its 2012 Draft Policy Updates to its Proxy Voting Guidelines. The 2012 Draft Policy Updates propose key changes to ISS' Proxy Voting Guidelines on executive compensation and corporate governance issues. ISS invites corporate issuers, institutional investors and governance market participants to provide feedback on these proposed Policy Updates by submitting comments via email to policy@issgovernance.com. The comment period closes on October 31, 2011.

The following summarizes the key proposed changes to ISS' executive compensation and corporate governance policies.

- ISS will recommend **case-by-case** on Compensation Committee members (or in rare cases where the full board is deemed responsible, all directors) **and** the current Management Say on Pay proposal if the company's prior Say on Pay proposal received **significant opposition** from votes cast, taking into account a variety of qualitative factors.
- ISS will evaluate Management Say on Pay proposals in the U.S. taking into consideration **three threshold factors** to determine whether a pay-for-performance disconnect warrants an AGAINST recommendation:
 - The degree of alignment between the company's TSR rank and CEO total pay with the company's ISS developed peer group, as measured over one-year and three-year periods;
 - The multiple of the CEO's total pay relative to the peer group median; and
 - The alignment between the trend in CEO's pay and the company's TSR over the prior five fiscal years.
- ISS will recommend Withhold/Against votes on **all** incumbent director nominees if the board implements an advisory vote on executive compensation on a less frequent basis than the frequency which received **a majority of votes cast** at the most recent shareholder meeting at which shareholders voted on the frequency of Say on Pay voting.
- ISS will evaluate proxy access shareholder proposals on a **case-by-case basis**, taking into consideration a variety of factors including the ownership threshold set forth in the shareholder proposal (e.g., percentage and duration).
- ISS will vote **case-by-case** with respect to all IPO companies that seek shareholder approval of their equity plan proposals for the first time to qualify for favorable tax treatment under the provisions of Section 162(m) of the Internal Revenue Code.

Below are detailed descriptions of the key changes under the proposed Policy Updates to ISS' Proxy Voting Guidelines.

Board Response to Management Say on Pay (MSOP) Votes

The draft Policy Updates clarify that where a company's prior MSOP proposal received **significant opposition** from votes cast, ISS will determine on a **case-by-case** basis its vote recommendation on Compensation Committee members (or in rare cases where the full board is deemed responsible, all directors) **and** on the a company's current MSOP proposal, taking into account the following factors:

- The level of opposition;
- The company's ownership structure;
- Disclosure of engagement efforts with major institutional investors regarding compensation issue(s);
- The company's response;
- Specific actions taken to address the issue(s) 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 and whether any prior issues of concern are recurring or one-time.

A higher level of scrutiny will be placed on companies where the MSOP proposal received less than 50% support from all votes cast. Further, the recurrence of previously identified compensation issues or newly identified compensation concerns, depending on the severity, may result in an AGAINST vote on MSOP and Compensation Committee members.

Meridian Comment: *The SEC's Say on Pay rules require companies to disclose in their CD&A whether and how their compensation policies and decisions have taken into account the results of the most recent Say on Pay vote. For companies that received significant opposition from the votes cast on the MSOP proposal this year, ISS' proposed Policy Updates provide that ISS expects specific action to address the compensation issue(s) that resulted in significant opposition. ISS does not define "significant opposition" in the proposed Policy Updates, but we expect that less than 50% support will warrant an explicit response from a company before the next shareholder vote. However, ISS is requesting comment on whether a support level of less than 70% warrants an explicit response from a company to address concerns. However, given Say on Pay voting results during the recently completed proxy season, very few companies would warrant heightened scrutiny by ISS under either threshold during the 2012 proxy season.*

Evaluation of Executive Pay (Applicable to MSOP Proposals)

Under current ISS Policy Guidelines, ISS will frequently recommend **AGAINST** a MSOP proposal when ISS identifies a CEO pay-for-performance disconnect. The determination of a pay-for-performance disconnect is a two stage process. If ISS determines that a company's 1- and 3-year total shareholder returns (TSRs) fall below the median of its 4-digit GICS industry group, it will then assess the company's CEO pay practices against certain qualitative factors, including the year-over-year change in the CEO's total pay and the changes in CEO pay relative to the a company's five-year TSR to determine whether pay and performance are misaligned.

Beginning in 2012, ISS proposes to use a **new methodology** to evaluate pay-for-performance alignment, which will identify companies that have demonstrated strong, satisfactory, or weak alignment between TSR and CEO pay over an extended period. The new methodology incorporates a quantitative analysis, followed (as applicable) by further qualitative analysis. The quantitative pay-for-performance analysis assesses CEO pay against the following criteria:

- **Relative Alignment.** Under the relative alignment criteria, ISS will assess a company's CEO pay-performance alignment relative to a group of companies similar to the company in market cap, revenue (or assets), and industry ("peer group") based on the following factors:
 - The degree of alignment between the company's TSR rank and the CEO's total pay rank within the peer group, as measured over one-year and three-year periods (weighted 40/60);
 - The multiple of the CEO's total pay relative to the peer group median (this may identify cases where a high performing company may nevertheless be overpaying).

The peer group is generally comprised of 14-24 companies that are selected on the basis of market cap, revenue (or assets for financial firms), and GICS industry group, via a process designed to select peers that are **closest to the subject company in terms of revenue/assets and industry and also within a market cap range that is reflective of the company's life cycle maturity phase.** Currently, ISS formulates its peer group based on those Russell 3000 companies within a company's GICS industry group, irrespective of the size of the peer companies.

- **Absolute Alignment.** Under absolute alignment criteria, ISS will evaluate the trend in CEO pay and the company's TSR over the prior five fiscal years – i.e., the difference between the slope of annual pay changes and the slope of annualized TSR changes during the prior 5-year period.

Relative Alignment and Absolute Alignment may be weighted 50/50. Companies that demonstrate strong or satisfactory alignment will generally receive a positive recommendation (in the absence of other pay-related issues), while companies demonstrating weak alignment will receive further qualitative review to determine a final vote recommendation.

The qualitative review considers the following:

- The ratio of performance- to time-based equity awards;
- The overall ratio of performance-based compensation;
- The robustness of disclosure and rigor of performance goals;
- The company's peer group benchmarking practices;
- Actual results of financial/operational metrics, such as growth in revenue, profit, cash flow, etc., both absolute and relative to peers;
- Special circumstances related to, for example, a new CEO in the prior fiscal year or equity grant practices (e.g., biannual awards); and
- Any other factors deemed relevant.

Meridian Comment: *ISS does not anticipate a significant change in the number or percentage of negative recommendations issued due to the proposed change in its pay for performance policy. This proposed Policy Update continues to provide a multi-factor analysis to pay-for-performance evaluations, while putting more emphasis on long-term alignment and on pay and performance relative to the company's market peers, as well as the overall alignment of CEO pay and TSR performance trends over five years. The wild card in ISS' proposed pay for performance evaluation will be the manner in which it develops relative peer groups. Its current approach has come under significant criticism by corporate issuers as often developing inappropriate peer groups. We have long recommended that ISS develop peer groups that better relate to a company's revenue size, business operations, and market capitalization.*

Board Response to Management Say on Pay Frequency Vote

ISS is proposing the following new proxy voting policies with respect to the decision of a company's board of directors as to the frequency of holding say on pay vote:

- Vote **WITHHOLD/AGAINST** on **all** incumbent director nominees if the board implements an advisory vote on executive compensation on a **less frequent basis** than the frequency which received the majority of votes cast at the most recent shareholder meeting at which shareholders voted on the say-on-pay frequency.
- Vote **CASE-BY-CASE** if the board implements an advisory vote on executive compensation on a less frequent basis than the frequency which received a plurality, but not majority, of votes cast at the most recent shareholder meeting at which shareholders voted on the say-on-pay frequency, taking into account:
 - The board's rationale for choosing a frequency that is different from the frequency which received a plurality;
 - The company's ownership structure;
 - 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.

Meridian Comment: *Since very few companies have adopted a say on pay vote frequency that did not receive a plurality or majority of the votes cast, we expect that this proposed ISS policy would **not** impact the vast majority of companies for the 2012 proxy season.*

Shareholder Proposals Seeking to Establish Proxy Access Procedures

On September 20, 2011, the Securities and Exchange Commission's amendment to Rule 14a-8 providing that companies may **not** exclude from their proxy materials shareholder proposals for proxy access procedures took effect.

ISS's current policy on a shareholder resolution asking for open access or proxy access is to evaluate the resolution on a **case-by-case** basis taking into account the ownership threshold proposed in the resolution and the proponent's rationale for the proposal at the targeted company in terms of board and director conduct.

Under the proposed policy for 2012, ISS would continue to evaluate proxy access proposals on a **case-by-case basis** in determining a vote recommendation taking into account certain additional factors. The proposed policy is described below:

- Vote CASE-BY-CASE on shareholder proposals seeking proxy access, taking into account, among other factors:
 - The proponent's rationale for the proposal at the targeted company;
 - The ownership thresholds proposed in the resolution (e.g., percentage and duration);
 - The maximum number of directors that shareholders may nominate each year; and
 - The method of determining which nominations should appear on the ballot if multiple shareholders submit nominations

Meridian Comment: *Significant shareholder proposals on proxy access were last seen in 2007, when Hewlett-Packard (42% support), UnitedHealth Group (45% support), and Cryo-Cell International (majority support) were the targets of such proposals. The number of proposals that will appear on company ballots in 2012 and the level of specificity those proposals will entail remain to be seen.*

Recent IPO Companies Proposing Equity Plans to Comply with Section 162(m)

Under a proposed IRS rule related to Section 162(m) of the Internal Revenue Code, IPO companies will need to obtain shareholder approval before awarding certain performance-based restricted stock units to named executive officers to qualify them as performance-based compensation and therefore, deductible under Section 162(m). ISS anticipates an increase in IPO companies seeking shareholder approval for performance-based restricted stock units.

Generally, ISS has recommended that investors support equity plan proposals solely for compliance with Section 162(m) of the Internal Revenue Code, due to the favorable tax deduction companies may take on performance-based compensation paid named executive officers. However, in its draft policy update, ISS notes that such support may not be warranted when an equity plan contains shareholder unfriendly provisions (e.g., repricing provisions, evergreen share pool, liberal change in control definitions). ISS concludes that such support may result in a more adverse and lasting impact on shareholders than a potential loss of tax deductions related to named executive officer compensation. This conclusion forms the basis for the following ISS proposed policy with respect to IPO companies.

- Vote **CASE-BY-CASE** with respect to all IPO companies that seek shareholder approval of their equity plan proposals **for the first time**, to qualify for favorable tax treatment under the provisions of Section 162(m). A full equity plan analysis, including consideration of total shareholder value transfer, repricing, burn rate analysis (if applicable) and liberal change in control, will be conducted. Other factors such as pay for performance or problematic pay practices as related to MSOP may be considered, if appropriate.
- Any other factors deemed relevant.

Meridian Comment: *ISS anticipates that it will continue to support the vast majority of Section 162(m) proposals by IPO companies that do not seek additional shares. Most equity plans submitted for Section 162(m) approval contain shareholder-friendly features, such as prohibition on repricing/option exchanges. Therefore, ISS anticipates that the proposed policy change would have minor impact. Nevertheless, recent IPO companies seeking shareholder approval of an equity plan solely for Section 162(m) purposes should review their plan documents for compliance with ISS policies.*

ISS will release its final 2012 U.S. and International Policy Updates during the week of November 14 and its Global Policy Summary and Concise Guidelines in December.

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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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