

Meridian Client Update

ISS Releases FAQs on 2012 U.S. Compensation Policies

On January 25, 2012, Institutional Shareholder Services (ISS) released frequently asked questions (FAQs) on its 2012 U.S. Compensation Policy. These FAQs cover three key categories of ISS policies: (i) pay for performance, (ii) responsiveness of management to say on pay (Say on Pay) vote outcomes, and (iii) equity plan proposals. This Client Update provides a summary of the FAQs.

FAQs on ISS's Pay for Performance Policy

In November 2011, ISS launched its new methodology for evaluating CEO pay for performance. ISS's evaluation of CEO pay relative to performance will influence its vote recommendations on a company's Say on Pay proposal, compensation committee members who are up for reelection and equity plan proposals. The new pay for performance methodology is applicable to public companies that hold shareholder meetings occurring on or after February 1, 2012. For Russell 3000 companies, ISS will initially perform the following two-part Quantitative Analysis to determine whether a disconnect exists between CEO pay and a company's total shareholder return (TSR) performance (capturing stock price appreciation and dividends) over an extended period:

- **Part I: Relative Alignment Analysis:** Under the relative alignment analysis, ISS will determine:
 - The degree of alignment between a subject company's TSR rank and the CEO's total pay rank within an ISS composed peer group, as measured over one- and three-year periods (weighted 40%/60%, respectively) ("RDA"); and
 - The multiple of the CEO's total pay relative to the peer group median ("CEO pay ratio").
- **Part II: Absolute Alignment Analysis:** Under the absolute alignment analysis, ISS will determine the difference between the trend in annual changes in CEO total pay and the trend in the subject company's annualized TSR over the prior five fiscal years ("Absolute Alignment").

The outcomes from the Quantitative Analysis are assessed through ISS's scoring matrix to determine whether a "high" concern level exists with respect to any one of the three tests described above. If the scoring matrix yields a high concern level, or two or more medium concern levels, then ISS will assess up to six subjective factors (the "Qualitative Analysis") to determine whether a subject company's pay practices mitigate or facilitate the perceived disconnect between pay and performance.

- **CEO Total Pay.** The FAQs provide the following guidance as to the definition of CEO total pay and the determination of CEO total pay under various circumstances:
 - **Definition of CEO Total Pay.** ISS is continuing the definition of CEO total pay that it used under its prior pay for performance methodology. CEO total pay is determined by taking the sum of the compensation disclosed in a subject company’s Summary Compensation Table, except for stock option/SAR awards which ISS values based on the awards’ full term (FAS 123R values equity awards based on their “expected term”). ISS’s approach results in award values greater than the values generated under the accounting rules.
 - **Multiple CEOs over testing periods.** The Quantitative Analysis will evaluate CEO total pay for each year in the analysis without regard to whether all years are the same or different CEOs.
 - **Multiple CEOs employed during same fiscal year.** If a company has more than one CEO during a fiscal year, the Quantitative Analysis will only consider compensation paid to the CEO who was in that position **at the end of the fiscal year**. The base salary for a CEO serving less than one year will be annualized.
 - **Co-CEOs employed during same fiscal year.** If the company has co-CEOs, the Quantitative Analysis will only consider compensation of the highest paid co-CEO. However, the impact of co-CEO compensation costs may be addressed separately as part of ISS’s qualitative assessment.
 - **Determination of CEO total pay at peer companies.** ISS will develop CEO total pay at peer companies based on these companies’ most recent proxy filings. This means that when a peer company’s fiscal year 2011 pay data is not available, CEO total pay for that peer company will be based on fiscal year 2010 disclosures (and earlier fiscal years, as applicable).

- **Peer Group Development.** A subject company’s peer group will generally be composed of 14 to 24 companies selected by ISS. Peer groups are generally constructed with reference to the subject company’s industry (based on GICS classification), revenue (or assets with respect to financial services companies) and market value. The FAQs provide the following guidance on peer group development:
 - **Treatment of subject company.** A subject company is not treated as a component company of its peer group for any purpose under ISS’s pay for performance methodology.
 - **Peer groups with more than 14 component companies.** If more than 14 companies within a subject company’s 6-digit GICS group meet the applicable size criteria (i.e., market cap and revenue/assets), then ISS **may** select up to 24 of those companies for inclusion in the peer group. *The FAQs do not specifically indicate how ISS will make this selection.*
 - **Peer groups with less than 14 component companies.** If less than 14 companies in the subject company’s 6-digit GICS group meet the size criteria, additional companies that do meet the size criteria will be selected from the broader GICS category until a minimum of 14 peer companies are identified. In a limited number of cases—where size and industry parameters are difficult to satisfy—ISS may use a minimum 12-member peer group for a subject company’s Quantitative Analysis. Alternatively, ISS may apply **other criteria** to construct a reasonable peer group. *The FAQs do not provide guidance regarding this “other criteria” for constructing a peer group.*

- **Peer group median revenues relative to subject company’s revenues.** In its technical white paper on the new pay for performance methodology, ISS notes that its peer group selection process ideally will result in the subject company’s revenues approximating peer group median revenues. The FAQs make clear that this “ideal outcome” is not part of ISS’s selection criteria but merely a potential result of the selection process. ISS’s methodology does not require that a subject company’s revenues equal peer group median revenues.
- **Minimum public life of peer companies.** Generally, only companies with three full years of data may be included in a peer group. In limited circumstances, a company with less than three years of data may be included in a peer group when the Quantitative Analysis relates solely to a single year (see discussion below).

Meridian Comment. *We have seen cases where ISS has constructed a peer group which includes component companies that do not meet ISS’s applicable size criteria (i.e., revenue/asset or market capitalization). ISS has informally advised Meridian that there is “allowable variance” around the size criteria. The FAQs provide no additional guidance regarding this allowable variance.*

- **Application of RDA Analysis, CEO Pay Ratio Analysis and Absolute Analysis.** The FAQs provide the following guidance on application of RDA analysis, CEO pay ratio analysis and Absolute analysis.
 - **Subject company is traded for less than five years.** If a subject company has been publicly traded for less than five fiscal years but more than three fiscal years, the one-year and three-year RDA analysis and CEO pay ratio analysis will apply to the company. The company’s limited life as a publicly traded company will be considered as part of any qualitative evaluation.
 - **Subject company is traded for less than three years.** If a subject company has been publicly traded for less than three fiscal years but more than one fiscal year, the one-year RDA analysis and CEO pay ratio analysis will apply to the company. The company’s limited life as a publicly traded company will be considered as part of any qualitative evaluation.
 - **Treatment of subject company pay and TSR data when determining peer group TSR and peer group median CEO total pay.** Neither the CEO total pay nor the TSR of a subject company is included in the determination of median CEO total pay or TSR statistics of the subject company’s peer group.

Meridian Comment. *ISS has informally advised Meridian that newly public (less than one year) companies will be subject solely to the Qualitative Analysis under the new pay for performance methodology.*

- **Prospective Pay for Performance Commitments.** Under its prior policy, ISS would take into consideration a company’s **prospective** pay for performance commitment when formulating its Say on Pay vote recommendations. Under current policy, ISS will take into consideration a company’s proxy disclosed pay programs, and any changes to existing awards that support a company’s pay for performance philosophy (e.g., to add performance-based vesting conditions to such awards). However, additional filing materials made after the publication of ISS’s proxy research report that indicate future changes planned for the pay program will have **minimum impact** on ISS’s Say on Pay vote recommendation.
- **Impact of Pay for Performance Disconnect on Equity Plan Proposals.** If a significant portion of a CEO’s misaligned pay is attributed to non-performance-based equity awards and there is an equity

plan on the ballot with the CEO as one of the participants, ISS may recommend a vote **AGAINST** the equity plan. ISS will consider the following factors in formulating its vote recommendation on a company's equity plan proposal: (i) magnitude of CEO pay misalignment; (ii) contribution of non-performance-based equity grants to overall pay; and (iii) the proportion of equity awards granted in the last three fiscal years concentrated at the named executive officer (NEO) level.

The FAQs provide guidance regarding problematic concentration levels of equity grants at the NEO level. Specifically, ISS will subject an equity plan to greater scrutiny where the concentration ratio for the NEOs exceeds 25%. In such a case, ISS will look at the past three years of concentration ratios with and without the CEO, and consider the following:

- Is the concentration high due to the CEO or is there more/less equal distribution among the key executives?
- Is the LTI program similar for the CEO and the top five executives?
- Are there performance features for the equity awards and is it the same for all top five executives?

FAQs on ISS's Policy on Management Say on Pay Responsiveness

Where a Board has failed to respond to **significant opposition** to a company's prior year Say on Pay proposal, ISS will determine its vote recommendation on Compensation Committee members CASE-BY-CASE. Under ISS's new policy, "significant opposition" occurs when a company's prior year Say on Pay proposal received **less than 70% of votes cast**. In such instances, ISS will determine **CASE-BY-CASE** its vote recommendation on Compensation Committee members (or, in exceptional cases, the full board) **and** on a company's current Say on Pay proposal, taking into account the following factors: (i) the company's response to the Say on Pay vote outcome, (ii) whether the issues raised by the Say on Pay vote are recurring or isolated; and (iii) the company's ownership structure.

The FAQs provide the following guidance on ISS's policy on management's response to a company's Say on Pay vote.

- **ISS's recommended disclosure policy regarding company responses to Say on Pay vote outcome.** As a general matter, ISS recommends that all companies disclose in their proxy statements the key actions taken in response to their Say on Pay vote outcome, regardless of the level of shareholder support.
- **ISS's assessment of a company's response to Say on Pay vote outcome.** ISS will consider all aspects of a company's response to its Say on Pay vote outcome, including proxy disclosure of the company's engagement with shareholders and the decisions and actions flowing from that engagement. ISS will also consider the nature of the issue(s) perceived to have caused high opposition and their impact going forward.
- **Impact of prior year low or negative support on Say on Pay on ISS's vote recommendation on directors.** In general, if a company receives low or negative support on its prior year Say on Pay proposal, ISS will issue a negative vote recommendation on compensation committee members (and/or full board in rare cases) under the following two conditions:
 - If an issue is deemed sufficiently egregious to warrant a negative recommendation; and

- If ISS determines that the board has failed to respond adequately to issues that led to high opposition to the prior Say on Pay proposal.

FAQs on Equity Plans

The FAQs on equity plans address the applicability of ISS's governance policies on equity plan proposals made by newly public companies and changes to the inputs used to determine the cost of equity plans under ISS's shareholder value transfer model.

- **Recent IPO Companies.** Any equity plan proposals put to shareholders by a newly public company will be subject to the full range of ISS's governance policies, including assessment of the equity plan's cost under ISS's proprietary shareholder value transfer model.
- **Change to ISS's SVT Model for Evaluating Equity Plan Proposals.** Two important inputs used in ISS's SVT model relate to a subject company's share volatility and dividend yield. For 2012, the determination of these two inputs has been changed from a 200-day average to three-year historical volatility and five-year average dividend yield, respectively. Generally, this change will apply to equity plan proposals made by companies with shareholder meetings occurring after February 2012.

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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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