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's 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 advising companies on its proxy voting guidelines on a variety of compensation-related topics, including Say on Pay, problematic pay practices, CEO pay-for-performance alignment, board responsiveness to pay issues and equity plan proposals. ISS also rates companies' governance policies under its Governance QuickScore (IGQ), a governance rating methodology designed to reflect current best practices. ISS's IGQ analysis on U.S. companies includes 34 compensation-related factors.

How influential is ISS?

ISS's influence is potentially concerning given its near "one-size-fits-all" approach to evaluating corporate governance and executive compensation practices. In 2011 and 2012, Russell 3000 companies that received an ISS AGAINST recommendation on their Say on Pay proposals typically saw significantly depressed levels of shareholder support by 25% to 30% relative to shareholder support at Russell 3000 companies that received a positive ISS vote recommendation.

In 2012, ISS recommended shareholders vote "AGAINST" approximately 13% of U.S. public companies' Say on Pay proposals. While only 2.5% of companies ultimately failed Say on Pay in 2012, all but two companies that failed received an ISS AGAINST recommendation.

The following factors cause ISS to recommend AGAINST a Say on Pay proposal:

- CEO pay-for-performance misalignment;
- The presence of "egregious" pay practices;
- The presence of significant problematic pay practices; or
- The Board exhibits a significant level of poor communication and responsiveness to shareholders.

What actions should a company take to be well-prepared for ISS's impact on shareholders?

In light of ISS's influence, companies should consider several actions to help ensure successful vote results at its shareholders meeting:

- Request a draft copy of ISS's Proxy Report, which will be available 24–48 hours before ISS issues its final report, and prepare to comment on any factual inaccuracies or harsh but irrelevant rhetoric in the report (ISS will only issue a draft copy of its Proxy Report to Standard & Poor's 500 companies);
- Know the proxy voting policies of the company's institutional base and other major shareholders;
- Communicate with top institutional investors through direct shareholder engagement; and
- Consider filing supplemental materials to communicate with shareholders.

The Details

Given ISS's influence over proxy voting outcomes, companies should be aware of ISS's Proxy Voting 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's Vote Policies

ISS's Proxy Voting Guidelines provide that ISS will recommend a vote **AGAINST** a management Say on Pay (MSOP) proposal if:

- There is a significant misalignment between CEO pay and company performance ("Pay-for-Performance Policy");
- The company maintains significant problematic pay practices ("Policy on Problematic Pay Practices"); or
- The board exhibits a significant level of poor communication and responsiveness to shareholders ("Policy on Board Responsiveness").

ISS's Policy Guidelines further provide that ISS will recommend a vote **AGAINST** or **WITHHOLD** from the members of the Compensation Committee (and potentially the full board) if:

- There is no MSOP proposal on the ballot, and an AGAINST vote on an MSOP is warranted due to the presence of one or multiple of the factors listed above;
- The board fails to respond adequately to a previous MSOP proposal that received less than 70% support of votes cast;
- The company has recently practiced or approved problematic pay practices, including option repricing or option backdating; or
- The situation is egregious.

Pay-for-Performance Policy

ISS substantially overhauled its pay-for-performance analysis in advance of the 2012 proxy season. Under this analysis, ISS evaluates whether a misalignment exists between CEO total pay and company performance, on both a relative and absolute basis. Initially, for Russell 3000 companies, ISS will assess CEO total pay against three quantitative tests (Quantitative Analysis). If the Quantitative Analysis determines that significant pay misalignment exists, ISS will perform a more in-depth qualitative assessment taking into consideration a number of unweighted factors to determine whether a company's pay practices mitigate or facilitate the misalignment. ***When the qualitative assessment shows that the pay misalignment is facilitated by company pay practices, ISS will likely recommend an AGAINST vote on a company's Say on Pay proposal***.

- **Quantitative Analysis**. Under the Quantitative Analysis, for Russell 3000 companies ISS assesses CEO total pay against the following three quantitative tests:

  — Degree of alignment between total shareholder return (TSR) rank and CEO's total pay rank (based on grant date value average pay), over 1- and 3-year periods (weighted 40%/60%), relative to an ISS developed peer group;

  — The multiple of the CEO's total pay relative to the peer group median pay; and

  — The 5-year historical trend in annualized CEO pay and TSR.

For the two quantitative tests measured on a relative basis, ISS revised its peer group selection process for 2013. The ISS peer group is generally comprised of 14-24 companies that are selected using market cap, revenue (or assets for certain financial firms), GICS industry group and the subject company's proxy-disclosed peers' GICS industry group within ISS's size constraints, 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 bucket that is reflective of the company's. The new ISS peer group selection methodology prioritizes the following factors in constructing the peer group: (1) peers within the subject company's 8-digit GICS category; (2) maintaining the subject company size at or near the median revenues/assets of its peer group; and (3) maintaining the approximate distribution of GICS industry codes as reflected in the company's proxy-disclosed peer group.

The outcomes from the foregoing quantitative tests are assessed through ISS's scoring matrix to determine whether a "low," "medium" or "high" concern level exists with respect to the company's pay-for-performance alignment. If the scoring matrix yields an overall medium or high concern level, ISS will undertake a further in-depth qualitative analysis to determine causal or mitigating factors relating to apparent pay misalignment (Qualitative Analysis).

Irrespective of the overall concern level that ISS assigns to a company based on the foregoing quantitative tests, ISS has clarified in a 2013 Frequently Asked Question (FAQ) that it will nonetheless perform a qualitative assessment as part of its holistic review of the company's pay programs. ISS may recommend an AGAINST vote on a company's Say on Pay proposal based on this qualitative evaluation. According to the FAQ, the qualitative evaluation will generally focus on problematic incentive designs such as multi-year guaranteed payments, discretionary pay components, and lack of rigorous performance goals.

- **Qualitative Analysis**. The Qualitative Analysis considers the following factors to determine how various pay elements may work to encourage or to undermine long-term value creation and alignment with shareholder interests:

  — The ratio of performance- to time-based equity awards;

  — The ratio of performance-based compensation to overall compensation;

  — The completeness 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 year or anomalous equity granting practices (e.g., biannual awards);

  — Realizable pay compared to grant pay;

  — Any other factors deemed relevant.

Policy on Problematic Pay Practices

ISS may recommend against a company's Say on Pay proposal if the company has engaged in what ISS deems to be significant "problematic pay practices." ISS's Proxy Voting Guidelines identify a select number of these pay practices that are considered "most egregious." ISS policies indicate that the presence of an egregious pay practice, standing alone, is sufficiently problematic to warrant an AGAINST vote recommendation **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.

ISS's Egregious Pay Practices

ISS's proxy voting policies identify the following pay practices as "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).

ISS's Problematic Pay Practices

ISS's 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, i.e., contracts containing multiyear guarantees for salary increases, non-performance-based bonuses, or equity compensation.
- New CEO with overly generous new-hire package:
  - — Excessive "make whole" provisions without sufficient rationale;
  - — Any of the problematic pay practices listed in this policy.
- 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:
  - — Inclusion of additional years of service not worked that result in significant benefits provided in new arrangements.
  - — Inclusion of performance-based equity or other long-term awards in the pension calculation.
- Excessive Perquisites:
  - — Perquisites for former and/or retired executives, such as lifetime benefits, car allowances, personal use of corporate aircraft or other inappropriate arrangements.
  - — Extraordinary relocation benefits (including home buyouts).
  - — Excessive amounts of perquisites compensation.
- Excessive severance and/or CIC provisions:
  - — CIC cash payments exceeding three times base salary plus target/average/last paid bonus;

— New or materially amended arrangements that provide for CIC payments without loss of job or substantial diminution of job duties (single-triggered or modified single-triggered, where an executive may voluntarily leave for any reason and still receive the CIC severance package);

— New or materially amended employment or severance agreements that provide for an excise tax gross-up. Modified gross-ups would be treated in the same manner as full gross-ups;

— Excessive payments upon an executive's termination in connection with performance failure; and

— Liberal change-in-control definition in individual contracts or equity plans which could result in payments to executives without an actual CIC occurring.

- Tax Reimbursements: Excessive reimbursement of income taxes on executive perquisites or other payments (e.g., related to personal use of corporate aircraft, executive life insurance, bonus, restricted stock vesting, secular trusts, etc.; see also excise tax gross-ups above).
- 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: "Excessive" differential between CEO total pay and that of next highest-paid named executive officer (NEO).
- Other pay practices that may be deemed problematic in a given circumstance but are not covered in the above categories.

The existence of any of the problematic pay practices identified above is considered as part of ISS's holistic review of a company's compensation programs.

Policy on Board Responsiveness

Under ISS's Proxy Voting Guidelines, ISS will consider the following factors **CASE-BY-CASE** when evaluating ballot items related to executive pay on the board's responsiveness to investor input and engagement on compensation issues:

- Failure to respond to majority-supported shareholder proposals on executive pay topics; or
- Failure to adequately respond to the company's previous Say on Pay proposal that received the support of less than 70% of votes cast.

When a company's prior year MSOP proposal received **less than 70% of votes cast**, 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 MSOP proposal, taking into account the following factors:

- The company's response to the MSOP vote outcome, including:

— Disclosure of engagement efforts with major institutional investors regarding the issues that contributed to the low level of support;

— Specific actions taken to address the issues that contributed to the low level of support;

— Other recent compensation actions taken by the company;

- Whether the issues raised by the MSOP vote are recurring or isolated; and
- The company's ownership structure.

In cases where more than 50% of the votes cast opposed the prior year MSOP proposal, ISS expects companies to demonstrate the "highest degree of responsiveness" to the negative vote outcome.

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 six ISS governance policies is met:

- **Shareholder Valuation Transfer Cost Policy**—A company's equity plan will satisfy ISS's 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's proprietary SVT model.
- **Pay for Performance Policy**—ISS Pay-for-Performance Policy is applicable to a company if the following conditions are present:

  — ISS determines that the CEO's pay is misaligned under its pay-for-performance test;

  — A significant portion of the CEO's misaligned pay is attributed to non-performance-based equity awards;

  — The CEO is a participant in the equity plan.

  If the Pay-for-Performance Policy is applicable to a company, then ISS *may* recommend a vote AGAINST an equity plan proposal taking into consideration the following factors:

  — Magnitude of pay misalignment;

  — 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's 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's 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.
- **Liberal Change-in-Control Definition Policy**—A company will satisfy ISS's 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.
- **Problematic Pay Practices Policy**—A company will satisfy ISS's Problematic Pay Practices Policy if the equity plan is not a vehicle for ISS's identified problematic pay practices. ISS has identified two problematic pay practices that may result in an against recommendation with respect to a share request proposal: (i) guaranteed equity awards to executives; and (ii) tax gross-up provisions provided in the equity plan document.

ISS Governance QuickScore

In March 2013, ISS released a new corporate governance scoring tool referred to as ISS Governance

QuickScore (IGQ). IGQ is the latest in a line of ISS governance scoring tools. IGQ replaces ISS's two-year old Governance Risk Indicator (GRId) which replaced ISS's Corporate Governance Quotient (CGQ).

Under IGQ, ISS assesses a company's governance policies across the same four governance areas used in GRId: (i) Board Structure; (ii) Compensation; (iii) Shareholder Rights; and (iv) Audit Practices. Each governance area is divided into subcategories and each subcategory includes a set of questions, many of which are similar to GRId questions.

ISS assigns an undisclosed weight to each question based on the ISS determined correlation of the applicable governance issue and 16 performance measures. Based on each question score and weighting, ISS uses a proprietary algorithm to derive a "raw" score for each governance area. This raw score is converted into a relative score ranging from 1 to 10 for each governance area and for a relative overall score. The 1 to 10 score is a relative measure based on the raw score calculations of other companies in the applicable relative index or region (e.g., ISS groups the top 500 U.S. companies as a single index).

The most important item to note about ISS's latest governance scoring tool is that a company's IGQ score will **not** directly impact ISS's vote recommendation on any matter.

ISS offers companies the opportunity to view their IGQ factors and verify the data underlying its IGQ scores. Comments are automatically submitted to ISS's IGQ 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 IGQ score.