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ISS DRAFT 2012 POLICY CHANGES

On October 18, ISS issued draft policy changes for the 2012 proxy season for public comment. Four changes to its U.S. executive compensation policies were proposed, one of which affects ISS' evaluation of pay-for-performance alignment and will have significant implications for public corporations. The proposed changes can be viewed on ISS' website (www.issgovernance.com). The comment period ends October 31.

Evaluation of Executive Pay (Management Say-on-Pay)

Under current ISS policy, pay-for-performance alignment for Russell 3000 companies is assessed by examining a company's one- and three-year total shareholder return relative to all Russell 3000 companies in the same 4-digit GICS industry group and year-over-year change in CEO compensation. Generally, if both one- and three-year TSR are below median and there has not been a meaningful year-over-year reduction in CEO pay, the company is deemed to have a pay-for-performance disconnect. This subjects the company's overall executive compensation program to greater scrutiny and raises the likelihood that ISS will recommend "against" the company's management say-on-pay ("MSOP") proposal.

The proposed changes for 2012 impact the pay-for-performance evaluation in several notable respects:

- Peer Group – The peer group for the relative TSR calculations will no longer be all companies in a company's 4-digit GICS industry group. Instead, this peer group will be the same as ISS' pay comparison peer group, which will be formed on a new basis
    - Under the new approach, the peer group will consist of 14-24 companies (vs. 8-12 under the current policy) that are selected based on size and inclusion in the same GICS industry group. The primary size determinants will include market cap and revenue (or assets for financial companies). It is not clear whether the GICS industry group will be the same or a different grouping relative to current policy[1]
    - The addition of market cap size is to be "reflective of the company's life cycle maturity phase," but ISS has not provided guidance on how this will be determined

[1] GICS refers to the Global Industry Classification Standard ("GICS") developed and maintained by *Standard & Poor's* for the purpose of classifying companies into 2-digit sectors, 4-digit industry groups, 6-digit industries, and 8-digit sub-industries. ISS currently uses 4-digit industry groups for relative TSR calculations and 6-digit industries to form peer groups for CEO pay comparisons.

- <u>Relative Alignment</u> – rather than assessing CEO pay alignment based on one- and three-year relative TSR and the year-over-year change in CEO pay, the new method will evaluate both CEO pay and TSR on a relative basis over one and three years

  — The weighting between the two periods will be 40% on the one-year period and 60% on the three-year period "to put more emphasis on the longer term"

  — The weighted CEO relative pay rank will then be compared to the company's weighted TSR rank. Presumably, a grading system will be applied to the differences in ranks to identify strong alignment and weak alignment. This process appears similar to that employed by Glass Lewis, but differs in continuing to rely solely on TSR as the measure of performance vs. Glass Lewis' use of seven performance metrics

  — Also, the multiple of CEO total pay to the peer group median, which is a qualitative consideration based on the most recent year's pay under the current policy, will become quantified and expanded to include three-year CEO pay. This comparison is meant to assist in identification of high performing companies that "may nevertheless be overpaying"

- <u>Absolute Alignment</u> – similar to current ISS policy, CEO pay alignment will also be evaluated on an absolute basis against TSR over a five-year period. However, the analysis will assess the difference in the rate of change of annual pay vs. the rate of change of annual TSR

  — Under the current policy, a chart showing five-year indexed TSR and bar graphs of annual CEO pay is evaluated qualitatively[2]

  — Under the proposed new approach, we presume that a grading system will be applied to the differences in rates of change to identify strong alignment and weak alignment, similar to differences in relative pay and TSR ranks

The policy changes indicate that equal weight may be given to relative peer and absolute pay-for-performance alignments, with strong or satisfactory alignment receiving a positive say-on-pay vote recommendation (assuming no problematic pay practices that are sufficient for a negative vote recommendation). Companies with weak alignment will be subject to further qualitative review that considers the following:

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

- The overall ratio of performance-based compensation to total compensation (we presume that time-based options will not be considered performance-based because this has been ISS' historic position)

[2] Under the current policy, CEO total pay uses grant-date fair values for equity compensation rather than "earned" values. The proposed changes do not indicate that a change in this methodology is under consideration.

- The robustness of disclosure and rigor of performance goals

- 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., non-annual)

- Any other factors deemed relevant

The proposed changes are intended to bring a tighter and more systematic approach to identifying pay-for-performance disconnects, but not to result in higher negative vote recommendations. ISS does acknowledge that there will be differences in the companies identified under the proposed methodology compared to the current methodology. Many significant questions are raised by the proposed changes that, hopefully, will be addressed in the final policy updates to be issued mid- to late-November. These questions include:

- How does market cap size relate to a company's "life cycle maturity phase"?

- Will the .5 to 2 times size range remain in place for identifying peer companies?

- Will CEO total pay be calculated in the same manner (e.g., grant-date fair values for long-term equity incentives)?

- How will changes in CEOs during the three- and five-year measurement periods be handled?

- Will companies have access to a tool or methodology to assess quantitative results in advance of ISS reporting?

- Will there continue to be a "cure" if a company's quantitative evaluation indicates weak pay-for-performance alignment?

Equity Plans Related to Section 162(m)

This policy codifies a clarification issued earlier in 2011 concerning recent IPO companies submitting equity plans for shareholder approval following the post-IPO grandfathering period under IRC Section 162(m).[3] ISS' support will not be routine, but will consider, on a case-by-case basis, the presence of egregious plan provisions (e.g., evergreen formula, repricing and liberal change in control definition) and plan cost under its shareholder value transfer model.

Board Response to Management Say-on-Pay Vote

The Dodd-Frank Act, which mandated the MSOP vote, also requires companies to discuss in the subsequent CD&A whether the company's compensation policies and decisions have taken the

[3] Companies that are newly public have a limited exemption from 162(m) that generally requires shareholder approval of incentive plan material terms and conditions at the first shareholder meeting that occurs after the close of the third calendar year following the year of the IPO.

results of the most recent MSOP vote into consideration and, if so, how consideration of the vote affected the compensation policies and decisions. The proposed policy changes clarify that ISS' vote recommendations on the re-election of compensation committee members and the current MSOP proposal will consider, on a case-by-case basis, the prior MSOP vote outcome in cases of significant opposition based on the following:

- The level of opposition
- The company's ownership structure
- Disclosure of engagement efforts with major institutional investors regarding the 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
- ISS's current analysis of the company's executive compensation and whether any prior issues of concern are recurring or one-time

The proposal indicates that companies receiving less than 50% support will receive higher scrutiny, but ISS is requesting comments on whether this level should be raised to 70%. Recurring issues or the occurrence of new concerns, depending on severity, may result in "against" vote recommendations on the current MSOP proposal and the re-election of compensation committee members.

Board Response to Management Say-on-Pay Frequency Vote

In addition to MSOP votes, the Dodd-Frank Act required an advisory vote on the frequency with which MSOP votes should be held (i.e., every one, two or three years). ISS is proposing a new policy with respect to say-on-pay frequency as follows:

1. Vote "withhold"/ "against" all incumbent directors if the board implements a frequency that is less than a frequency that received majority support

2. Vote case-by-case if the board implements a frequency that is less than the frequency receiving a plurality, but not majority support, 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 pay practices

- The previous year's support level on the company's say-on-pay proposal

- The difference between the frequency adopted and the frequency supported by shareholders

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This letter is intended to alert compensation professionals about developments that may affect their companies and should not be relied on as providing specific company advice. General questions about this letter may be directed to Wendy Hilburn at 212-299-3707 or wjhilburn@fwcook.com. Copies of this letter and other published materials are available on our website at www.fwcook.com.