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ISS 2012 POLICY UPDATES

On November 17, ISS issued updates to its U.S., Canadian, European and other international voting policies for the 2012 proxy season that will apply to all publicly traded companies with shareholder meetings on or after February 1, 2012. The compensation-related policy updates are unchanged from the draft policy changes issued for comment in October. Additional guidance on the new approaches for selecting companies for peer groups and evaluating pay-for-performance alignment, which are of intense interest to companies, especially those with calendar year-ends, was not included and will be provided later in December. This letter updates our October 20 letter on the proposed policy changes for new information and clarification contained in the November 17 release. The updated policies can be viewed on ISS' website (www.issgovernance.com).

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 ("TSR") relative to all Russell 3000 companies in the same 4-digit GICS industry group[1] and year-over-year change in CEO compensation for CEOs who have served at least two consecutive fiscal years. Generally, if both one- and three-year TSR are below median and there has not been a meaningful year-over-year reduction in CEO compensation (e.g., 10% or more), 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 updated policy for 2012 refines the methodology for determining pay-for-performance alignment as follows:

- Peer Group – The peer group for the relative TSR calculations will no longer be all Russell 3000 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
  - The peer group will generally consist of 14-24 companies (vs. 8-12 under the current policy) that are selected based on size using market cap, revenue (or assets for financial firms) and GICS industry group. ISS clarified that it will seek to position the company being evaluated close to the median

[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.

- <u>Peer Group Alignment</u> – both CEO pay and TSR will be evaluated on a relative basis compared to a company's peer group over one and three years, weighted 40% and 60%, respectively

    - The weighted CEO relative pay rank will then be compared to the company's weighted TSR rank. The system for evaluating the ranks was not included and will be provided in the additional guidance to be issued in December. The new methodology raises an issue that existed under the old methodology, but had less impact, which is the potential for pay and performance for peer companies to be for different periods – both for the peer companies and compared to the company under evaluation – due to timing differences in fiscal year-ends and proxy filings. For example, besides the obvious misalignments due to different fiscal year-ends, an early calendar-year filer may be compared to calendar-year peers based on TSR data through the most recent calendar year, but compensation data through the prior calendar year because the peers have not yet filed their proxies

    - 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. Clarification was not provided whether this comparison will be expanded to include three-year CEO pay in addition to one-year pay

- <u>Absolute Alignment</u> – CEO pay alignment will also be evaluated on an absolute basis against TSR over a five-year period. This analysis will assess the difference between the trend in annual pay changes and the trend in annualized TSR during the period

    - The system for evaluating differences in rates of change to identify strong alignment and weak alignment was not included and will be provided in the additional guidance to be issued in December

The updated policy did not indicate whether a change from using grant-date fair values for equity compensation to earned values would be made. However, we expect that ISS will continue to use grant-date fair values and continue to value stock options assuming the maximum term rather than actual experience of how long options are outstanding prior to exercise, as used for accounting and disclosure purposes. Thus, companies granting options will be even more disadvantaged under the new methodology.

Companies with unsatisfactory alignment will be subject to further qualitative analysis that considers the following:

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

- The overall 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 fiscal year or anomalous equity grant practices (e.g., biennial awards); and

- Any other factors deemed relevant

The updated policy did clarify that a new CEO will not exempt a company from evaluation under the new methodology.

Incentive Plans and Tax Deductibility Proposals

This policy formalizes a clarification issued earlier in 2011 concerning recent IPO companies submitting equity (and cash bonus) plans for shareholder approval following the post-IPO grandfathering period under IRC Section 162(m).[2] ISS' support will not be routine, and the equity plan will be given a full equity plan evaluation.

Under its updated policy, ISS will generally recommend "for" proposals to approve or amend executive incentive plans if the proposal:

- Is only to include administrative features;

- Places a cap on the annual grants any one participant may receive to comply with the provisions of Section 162(m);

- Adds performance goals to existing compensation plans to comply with the provisions of Section 162(m) unless they are clearly inappropriate; or

- Covers cash or cash and stock bonus plans that are submitted to shareholders for the purpose of exempting compensation from taxes under the provisions of Section 162(m) if no increase in shares is requested

Recommend "against" such proposals if:

- The compensation committee does not fully consist of independent outsiders, per ISS' director classification; or

- The plan contains excessive problematic provisions

[2] 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.

Recommend case-by-case on such proposals if:

- In addition to seeking 162(m) tax treatment, the amendment may cause the transfer of additional shareholder value to employees (e.g., by requesting additional shares, extending the option term, or expanding the pool of plan participants). ISS will evaluate the shareholder value transfer ("SVT") in comparison with the company's allowable cap; or

- A company is presenting an equity plan to shareholders for Section 162(m) favorable tax treatment for the first time after the company's IPO. ISS will perform a full equity plan analysis, including consideration of total SVT, burn rate (if applicable), repricing, and liberal change in control. Other factors such as pay-for-performance or problematic pay practices as related to MSOP may be considered, if appropriate

The rationale for the policy update explains that the new policy aligns with the recently proposed Treasury rule related to Section 162(m) to require newly public companies to obtain shareholder approval before awarding certain performance-based restricted stock units to named executive officers before the end of the standard post-IPO transition period to qualify as performance-based compensation.

Board Response to High Levels of MSOP Opposition

The policy update clarifies that ISS' vote recommendations on the re-election of compensation committee members (or, in exceptional cases, the full board) and the current MSOP proposal will consider, on a case-by-case basis, the prior MSOP vote outcome when shareholder support is less than 70% taking into account the following:

- The company's response, 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 are recurring or isolated;
- The company's ownership structure; and
- Whether the support level was less than 50%, which would warrant the highest level of responsiveness

The rationale for the policy update stresses that company actions should be new and not a reiteration of existing practices, and companies should avoid "boilerplate" disclosure.

Board Responsiveness – Response to Frequency of Advisory Vote on Pay Results

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

- Recommend "against" or "withhold" from the entire board of directors (except new nominees, who should be considered case-by-case) if the board implements a frequency that is less than the frequency that received majority support

- Recommend case-by-case on the entire board if the board implements a frequency that is less than the frequency that received a plurality, but not majority support, taking into account:

  - The board's rationale for selecting a frequency that is different from the frequency that received a plurality;

  - The company's ownership structure and vote results;

  - ISS' analysis of whether there are compensation concerns or a history of problematic compensation practices; and

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

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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.