December 10, 2012

ISS CLARIFIES 2013 POLICY UPDATES

Last week, ISS conducted a webinar and released FAQs with further information on its updated policies for the 2013 proxy season.[1] Additional details were provided for ISS' new realizable pay analysis and its revised peer group selection process under the pay-for-performance evaluation. ISS' peer group selection methodology will use a company's disclosed self-selected peer group as a key input for selecting ISS peers. In an effort to ensure current groups for 2012 pay determinations are used, a web-based tool is available for companies to submit changes to their peer groups so long as the updated peer groups will be disclosed in the 2013 proxies. This tool will be available for use until December 21 and can be found at http://www.issgovernance.com/PeerFeedbackUS.

Realizable Pay

ISS previously announced that, for 2013, it will include an analysis comparing CEO realizable pay to its traditional grant-date definition of CEO compensation for large-cap companies identified as "high concern" on the quantitative assessment of its pay-for-performance evaluation. ISS has confirmed that "large cap" companies refer to those in the S&P 500. Further, ISS will provide calculated realizable pay in the proxy analysis reports for all S&P 500 companies next year, whether or not they are "high concern."

ISS has also clarified that the realizable pay performance period will be three fiscal years. Realizable pay will be the sum of relevant annual cash paid, equity and long-term cash awards granted, and other compensation provided during the performance period. Equity and long-term cash award values will be the sum of all awards granted during the performance period that were earned, vested, or exercised through the end of the period, plus target values for ongoing awards. Equity awards will be revalued using the stock price at the end of the performance period. Unexercised stock options and SARs will be revalued using a Black-Scholes option pricing model with valuation assumptions updated to the end of the performance period.

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[1] A summary of the policy changes can be found in our alert letters dated October 19, 2012 and November 19, 2012, available on our website. A replay of ISS' global policy webinar and presentation materials are available at http://www.issgovernance.com/webcasts/2013PolicyPerspectives. The FAQs on peer group selection are available at http://www.issgovernance.com/policy/USPeerGroupFAQ. Additional FAQs covering the full 2013 policy changes are expected to be released later this month.

Peer Groups

In forming peer groups for its pay-for-performance evaluations for Russell 3000 companies, ISS will utilize a company's self-selected compensation peer group to identify and prioritize potential ISS peers within and outside of the subject company's GICS sub-industry. ISS will focus initially on a company's 8-digit GICS sub-industry code, rather than the 6-digit industry code under its current policy, to identify peers that are more closely related. Selection criteria will continue to include screens for size using revenue, or assets for certain, but not all, financial companies[2], and market cap. In addition, ISS has relaxed the size criteria, especially for very small and very large companies.

The FAQs on peer group selection outline the following process for constructing a peer group:

- The set of potential peer companies is identified, which consists of companies meeting the ISS size criteria that are in the GICS industry classification of the subject company or its self-selected peers. Size criteria are summarized on the following page.
- The specific ISS peer group (generally 14 to 24 companies) is selected from the universe of potential peers in the following order:
    - ISS will first look in the 8-digit GICS code of the subject company and select from the qualifying companies.
    - ISS will then turn to the 8-digit GICS code (or codes) of the subject company's peers and select additional qualifying companies.
    - ISS will then turn to the subject company's 6-digit GICS code and select additional qualifying companies.
    - ISS will then turn to the 6-digit GICS code (or codes) for the subject company's peers and select additional qualifying companies.
    - ISS will finally turn to the subject company's 4-digit GICS code and select additional qualifying companies.
- When selecting from the potential peer companies, higher priority is given to companies that fall into one (or more) of the following categories:
    - Companies included in the subject company's disclosed peer group.
    - Companies naming the subject company in their own peer group.
    - Companies with "numerous" connections to the subject company's disclosed peers or companies that name the subject company as a peer (ISS refers to these companies as "first degree peers"). A company has a connection to a first degree peer if it is either named as a peer by a first degree peer or has named a first degree peer as one of its peers.
- In addition, lower priority is given to a company's self-selected peer if it is the only peer company in its 6- and 8-digit GICS code.

The FAQs contain a number of additional rules with respect to the implementation of this new process. For example, the new rules describe how the applicable peer group may be reduced to as few as 14 companies, depending on how many steps it takes to assemble a peer group (the general rule appears to be that the more the steps, the more likely it is the group will be closer to 14 companies). The rules further appear to suggest that the general methodology described above

[2] Assets will be used as the primary size measure for companies in the following 8-digit GICS codes: 40101010 Diversified Banks, 40101015 Regional Banks, 40102010 Thrifts & Mortgage Finance, 40202010 Consumer Finance, and 40201020 Other Diversified Financial Services.

may be overridden in some cases in the interests of positioning the issuer closer to median of the peer group. In limited cases, the peer group may include as few as 12 companies.

Our initial tests of the peer group methodology indicate that there could be multiple resulting peer groups for one company that meet ISS' stated criteria. This suggests there will be more room for ISS discretion in applying the new selection methodology. However, ISS states that its own back-testing of the changes demonstrated a significant increase in the number of companies showing at least 50% overlap between the ISS and company-disclosed peer groups. This development should be viewed positively by issuers.

The 2012 and 2013 peer group selection methodologies are compared below.

	2012 Policy	2013 Policy
Number of Peers	Generally 14 to 24 (minimum of 12)	No change
Revenue/Asset Criteria	0.5-to-2.0x subject co. size	0.4x-to-2.5x subject co. size; range expanded when revenue (or assets) is above \$10 billion or below \$200 million
Market Cap Criteria	0.2x-to-5.0x subject co. size	0.25x-to-4.0x low and high end of the subject co.'s market cap "bucket;" Large: \$10 billion and up Mid: \$1 billion to \$10 billion Small: \$200 million to \$1 billion Micro: \$0 to \$200 million
Selection Process	Choose peers from the subject co.'s 6-, 4-, or 2-digit GICS industry classification	Choose peers from the 8-, 6-, or 4-digit GICS industries of the subject co. or those industries represented in the subject co.'s self-selected peer group (discussed in greater detail above)
Consideration of Subject Co.'s Peer Group	None	Used as basis for identifying relevant GICS industries and prioritizing peers for inclusion
Intended Positioning	Place subject co. near the peer group median	No change
Special Peer Groups	Three industry-specific "super-mega" peer groups for the largest companies (i.e., revenues/assets > \$50B and market cap > \$30B)	None (i.e., no "super-mega" peer groups)

The modification to the market cap size criteria is substantial and will lessen the influence of market cap as a screen for excluding companies. For example, the applicable range for a mid-cap company with market cap of \$4 billion would now include companies with market caps ranging from \$250 million to \$40 billion (i.e., less than one-tenth to ten times the subject company's market cap). The new methodology means that small changes in market cap could have a significant impact on eligible peer companies. For example, the market cap for an ISS peer would be limited to \$4 billion if a company has a market cap of \$990 million, but \$40 billion if the company's market cap is \$1 billion.

ISS is providing companies the opportunity to inform ISS of changes to their 2012 compensation peer groups through a web-based submission tool. Therefore, companies that will disclose changes to their peer groups in their upcoming 2013 proxies should submit this information to ISS. In addition, companies that do not use a peer group to set executive pay can submit a list of representative peers for ISS' consideration. The tool will be available until December 21 and can be accessed at http://www.issgovernance.com/PeerFeedbackUS.

An important issue is how ISS intends to handle any changes in the issuer's peer group from the peer group disclosed in the 2012 proxy. The FAQs appear to indicate that, unless ISS is notified of the changes, they will not be taken into account, even if they are disclosed in the 2013 proxy. For example, suppose the 2012 proxy disclosed the peer group used for benchmarking 2011 compensation but did not describe changes in the peer group that were made as part of the process of benchmarking 2012 compensation. Absent updating using the ISS submission tool, it appears that these changes will not be taken into account.

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This letter is intended to alert compensation professions 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 Ken Sparling at 312-894-0034 or khsparling@fwcook.com, David Yang at 312-894-0074 or dkyang@fwcook.com or 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.