RADFORD ALERT

Institutional Shareholder Services (ISS) Announces Changes to Key Global Corporate Governance Policies

Overview

In response to input received via its annual policy survey and meetings with clients, Institutional Shareholder Services (ISS) recently announced several important policy changes impacting both the US and European markets. These changes go into effect for companies with annual shareholder meetings occurring on or after February 1, 2014, and Radford recommends clients begin to assess the impact of these changes before the New Year to prepare for the upcoming disclosure season.

In the US, changes to CEO pay-for-performance testing methodologies could alter future ISS voting recommendations on Management Say-on-Pay proposals. And in Europe, ISS is aiming for greater alignment between its policies and the current legislative environment across much of the continent. Below, our compensation consulting team highlights the policy updates most likely to have an impact on our client base.

US CEO Pay-for-Performance: *Simplification of the RDA Methodology*

The latest round of ISS policy updates will simplify the methodology for calculating Relative Degree of Alignment (RDA) scores under the existing ISS CEO pay-for-performance testing system. The current testing system, initially launched in 2011, uses three tests as follows:

- **Relative Degree of Alignment (RDA)** – This assessment currently ranks one- and three-year CEO compensation and one- and three-year stock price performance of the focus company against an ISS-selected comparator group to generate a blended alignment score weighted 40% over the one-year period and 60% over the three-year period. Going forward, ISS will only consider three-year performance. *See paragraphs below for full details on RDA test changes.*

- **Multiple of Median (MoM)** – This assessment currently compares one-year CEO compensation at the focus company to the comparator group's median level of CEO compensation in the same year. *No changes are proposed for the MoM test at this time.*

- **Pay-TSR Alignment (PTA)** – This assessment currently compares the five-year trend in CEO compensation at the focus company with its five-year trend in stock price performance (total shareholder return). This assessment does not factor-in any comparator group data. *No changes are proposed for the PTA test at this time.*

The new RDA methodology simplifies the assessment by eliminating the consideration of a one-year performance period. Going forward, the RDA test will only consider the ranking of three-year CEO compensation and three-year stock price performance of the focus company against an ISS-selected comparator group. There will no longer be a blended score across two time periods, which has generated uneven results at companies with highly volatile stock prices.

Per the current ISS release, the “low,” “medium” and “high” concern scoring ranges for the RDA assessment would remain the same as in previous years: “low” at below 30, “medium” at 30-49, and “high” at 50 or greater.

Radford Commentary – The sole emphasis on a three-year performance period, while consistent with typical long-term incentive measurement horizons, could penalize companies with shorter-term performance periods (e.g., one-year) or companies that do not use performance-based equity. Companies are advised to model RDA testing outcomes in advance of ISS recommendations to determine how this rule change could influence test results.

US CEO Pay-for-Performance: *Expansion of Realizable Pay Review*

In early 2013, ISS introduced a review of realizable pay as part of its CEO pay-for-performance assessments for S&P 500 companies. Any concerns raised by the review of realizable pay did not formulaically alter the standard RDA, MoM and PTA testing procedures mentioned above, but could serve to sway the recommendations of ISS analysts on a qualitative basis.

Upon introduction of this policy, Radford advised clients of all sizes to take note of the new rule, as we believed ISS would seek to expand the application of realizable pay assessments in the future; either across a wider set of companies or by making its testing more impactful on voting recommendations. Our thinking proved to be correct, as ISS will now expand reviews of realizable pay to S&P 1500 companies.

Radford Commentary **–** ISS currently conducts regular CEO pay-for-performance assessments for all companies listed on the Russell 3000 index, so continue to believe ISS will expand reviews of realizable pay to this entire group at some point in the future. Companies should take a proactive approach toward understanding how ISS calculates realizable pay (whether they are covered by the current policy or not); this includes monitoring realizable pay outcomes in a similar fashion to ISS and anticipating potential challenges down the road as large long-term awards approach the end of vesting periods or as executives plan to exercise shares.

Key European Policy Changes

In response to the current legislative climate in many European countries, ISS will expand its “global principles” for European compensation practices. The expanded guidelines will include the following new statements:

- There shall be a clear link between the company's performance and variable awards;
- There shall not be significant discrepancies between the company's performance and real executive payouts;
- The level of pay for the CEO and members of executive management should not be excessive relative to peers, company performance, and market practices; and
- Significant pay increases shall be explained by a detailed and compelling disclosure.

Key legislative initiatives driving this policy update include the growing trend in European countries of allowing shareholders to have binding votes on the remuneration of executive boards (e.g. the Swiss “Minder Initiative”) and attempts to enact limits on executive compensation, either in absolute terms (e.g., EU limits on banker bonuses) or tied to multiples of worker pay.

Radford Commentary – In broad respects, the new ISS guidelines for Europe attempt to resemble the impact of Dodd-Frank rules in the US. However, key regulatory decisions will still be made in the European Union and national parliaments, and these decisions could deviate from ISS policies. Therefore, as is the case in the US, communication with shareholders to ensure they understand the thinking behind compensation decisions will likely remain the key factor in successfully addressing any adverse recommendations from ISS.

Next Steps

Radford’s compensation consulting team communicates with ISS on a regular basis regarding policy issues, including the items listed above. Clients interested in providing feedback to ISS through Radford are encouraged to send their comments to **consulting@radford.com** or to connect with a member of their respective account team.

To provide comments directly to ISS, write to **policy@issgovernance.com**. Or to read the full ISS corporate governance policy release governing the 2014 proxy season, please click the following link: **http://www.issgovernance.com/files/2014USPolicyUpdates.pdf**.

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