ISS ISSUES WHITE PAPER ON NEW APPROACH IN EVALUATING PAY FOR PERFORMANCE ALIGNMENT

To Our Clients and Friends:


Composition of Comparison Groups

As described in our November 23, 2011 client alert, under ISS's pay-for-performance test, ISS first runs a quantitative analysis to determine if there is a "significant" unsatisfactory alignment of long-term pay and performance. This test will supersede the one- and three-year total shareholder return ("TSR") test that ISS has applied in the past. If the quantitative analysis demonstrates "significant misalignment" of long-term pay-for-performance, ISS will undertake a qualitative review to determine its voting recommendation on a company's say-on-pay proposal.

When calculating the values used in its quantitative analysis under its new approach, ISS constructs a comparison group of between 14 and 24 companies, based on the company's market capitalization, revenue or assets and GICS industry group (the "Comparison Group").

In establishing the Comparison Group, ISS first creates an initial list of companies in the same two-digit GICS universe as the subject company that satisfy the following requirements:

- each company is between 0.45 times and 2.1 times the subject company's annual revenues (or assets for financial companies); and
- each company has a market capitalization of between 0.2 times and 5 times the subject company's market capitalization.

Next, ISS narrows down the list of companies to those companies that are in the subject company's six-digit GICS category[1], with companies closest in size being selected first, while both larger and smaller companies are added to the list to keep the subject company near the median of the list. Peer
groups for all Russell 3000 companies analyzed under this methodology are constructed twice per year.

ISS indicates that there are approximately 25 non-financial companies within the Russell 3000 index that have insufficient industry peers using the methodology described above. It has grouped these companies into a special peer group for purposes of the pay-for-performance quantitative analysis discussed below.

For those companies for which the process described above results in fewer than 14 peers (aside from the group of 25 companies described above), ISS will expand the Comparison Group construction by relaxing the revenue (but not the market cap) parameter in the group selection process. Larger and smaller peers will be added in order to maintain the subject company as close to the median size level as possible.

Once the Comparison Group is determined, ISS will perform a number of quantitative tests as described below. The detailed information that ISS has provided with respect to the selection of peer groups for purposes of its pay-for-performance analysis will enhance the ability of companies and their advisers to assess in advance of filing their proxy statements what other companies ISS will be comparing them against and whether their pay practices pass ISS’ quantitative analysis or will be subject to the more detailed qualitative review.

Quantitative Evaluation of Pay-for-Performance Alignment

According to the white paper, ISS' new quantitative pay-for-performance model is intended to flag companies where a potential misalignment of pay and performance may exist, and has three main goals. First, it aims to measure alignment of pay and performance over multiple periods to capture the multiple year business and compensation plans' performance cycles. Second, it proposes to use various measures to assess alignment from distinct perspectives. Finally, it intends to provide more robust information about pay-for-performance concerns to investors and issuers by evaluating and reporting the degree of alignment found at individual companies. In order to implement these goals, ISS' new quantitative methodology will use three measures of alignment between executive pay and company performance: (1) "Relative Degree of Alignment;" (2) "Multiple of Median;" and (3) "Pay-TSR Alignment."

Relative Degree of Alignment. Relative Degree of Alignment is a relative measure that compares a company's CEO pay and TSR performance against those of the Comparison Group over one- and three-year periods. To calculate the Relative Degree of Alignment, ISS begins by determining the subject company's CEO pay percentile rank among its Comparison Group. This percentile rank is determined for both one- and three-year performance periods. Using both these percentile ranks, ISS calculates a combined percentile rank of the subject company's CEO pay among its Comparison Group based on 40% weighting for its one-year and 60% weighting for its three-year rank (the "Combined Pay Rank"). ISS then repeats the process using the subject company's TSR performance in order to determine the TSR performance combined percentile rank of the subject company among its Comparison Group (the "Combined Performance Rank"). Once the Combined Pay Rank and the Combined Performance Rank are determined, ISS subtracts the Combined Pay Rank from the
Combined Performance Rank to arrive at the Relative Degree of Alignment value. These values range between -100 and +100, with -100 representing high pay for low performance, while zero represents equal pay for performance. Positive values represent low pay for high performance.

**Multiple of Median.** Multiple of Median is a relative measure that compares the prior year's CEO pay to the median pay of the Comparison Group. The Multiple of Median is calculated by dividing a company's one-year CEO pay by the median pay for the Comparison Group, with a high multiple raising concern.

**Pay-TSR Alignment.** Pay-TSR Alignment is an absolute measure of the trend in CEO pay against the subject company's annualized TSR during the past five fiscal years. Pay-TSR Alignment is a standalone measure for which alignment is evaluated independently of other companies' performance and is intended to be a long-term measure of directional alignment between CEO pay and a company's TSR. Using weighted linear regressions, pay and TSR slopes are calculated for the past five-year period. Pay-TSR Alignment is calculated by subtracting the pay slope from the TSR slope.

After computing all three values, ISS identifies the companies that are "significant" outliers in each measure using empirical observations of the distribution of measures from prior years and the outcomes of 2011 management say-on-pay votes. ISS determined that the Relative Degree of Alignment has the greatest correlation to vote results and therefore ISS decided to weigh it more heavily in the overall evaluation. The following table sets forth the ranges of results that, either on a single measure or in combination with other measures, will trigger a high concern, resulting in ISS conducting its second-stage, qualitative evaluation of a company's compensation programs.

<table>
<thead>
<tr>
<th>Measure</th>
<th>Level that may trigger high concern in conjunction with other measures</th>
<th>Level that triggers high concern by itself</th>
</tr>
</thead>
<tbody>
<tr>
<td>Relative Degree of Alignment</td>
<td>-30</td>
<td>-50</td>
</tr>
<tr>
<td></td>
<td>~25&lt;sup&gt;th&lt;/sup&gt; percentile</td>
<td>~10&lt;sup&gt;th&lt;/sup&gt; percentile</td>
</tr>
<tr>
<td>Multiple of Median</td>
<td>2.33x</td>
<td>3.33x</td>
</tr>
<tr>
<td></td>
<td>~92&lt;sup&gt;nd&lt;/sup&gt; percentile</td>
<td>~97&lt;sup&gt;th&lt;/sup&gt; percentile</td>
</tr>
<tr>
<td>Pay-TSR Alignment</td>
<td>-30%</td>
<td>-45%</td>
</tr>
<tr>
<td></td>
<td>~10&lt;sup&gt;th&lt;/sup&gt; percentile</td>
<td>~25&lt;sup&gt;th&lt;/sup&gt; percentile</td>
</tr>
</tbody>
</table>

**Qualitative Evaluation**

If the quantitative analysis demonstrates "significant misalignment" of long-term pay-for-performance (presumably if the quantitative analysis results in a "high" level of concern), ISS will, as in past years, undertake a further qualitative review to determine its voting recommendation. The qualitative analysis will consider how the various pay elements interact to create long-term value that aligns with shareholder interests. This analysis may include consideration of the following:
Strength of performance-based compensation, based upon:

- the ratio of performance- to time-based equity awards;
- the ratio of performance-based compensation to total compensation;
- disclosure of performance metrics and goals;
- whether or not the performance metrics and goals are "challenging" in the context of past performance and goals;
- use of a single metric, or similar metrics, in either or both of the short- and long-term incentive programs; and
- disclosure of non-GAAP metrics;

- Peer group benchmarking practices;
- Actual results of financial/operational metrics, such as growth in revenue, profit, cash flow, etc., both on an absolute basis and relative to peers; and
- Any special circumstances, such as the appointment of a new CEO in the last fiscal year or "unusual" equity grant practices (e.g., bi- or triennial awards).

As in the past, if ISS finds a "pay-for-performance" disconnect under this review, it recommends "Against" the company's say-on-pay proposal or, if there is not a say-on-pay proposal, "Against" the directors who have served on the company's compensation committee.

[1] If fewer than 14 companies from the initial list of companies exist in a subject company's six- or four-digit GICS category, ISS will repeat the process using the four- or two-digit GICS category until 14 companies are selected.

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Gibson, Dunn & Crutcher's lawyers are available to assist in addressing any questions you may have regarding these issues. Please contact the Gibson Dunn lawyer with whom you work, or any of the following:

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