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ISS Issues Policy Updates for 2008 Proxy Season

ISS Governance Services (formerly Institutional Investor Services, and now a part of RiskMetrics Group) recently updated its U.S. corporate governance policies for the 2008 proxy season. These policies are used by ISS to determine its voting recommendations for its proxy advisory clients. As in past years, this year's updates include changes affecting executive compensation and corporate governance issues, as well as revisions to the formula ISS uses to evaluate equity plan proposals. In the compensation area, the policy updates specifically address shareholder advisory votes on executive pay, ISS' "burn rate" computation, the stock option overhang calculation for certain companies, and poor pay practices. The updated policies are effective for annual shareholder meetings held after February 1, 2008.

Significance of ISS Policies

As an advisor to the institutional investor community for many years, ISS has established itself as a bellwether for the key shareholder issues each proxy season. For several years, ISS has regularly published and annually updated its standards on good corporate governance. These standards, which are contained in a series of policy statements, are used by ISS to formulate the voting recommendations on annual shareholder meeting proposals that it provides to its clients, as well as to analyze companies' corporate governance practices.

While most high-technology companies focus on the policy updates that affect their corporate governance structure and executive compensation programs, the updates actually encompass a broader range of shareholder issues, including auditing practices and a number of corporate responsibility matters (such as energy efficiency, internet privacy, operations in high-risk markets, and product safety).

This article summarizes the policy updates that affect executive and equity compensation matters.

Advisory Vote on Executive Pay

The past two years have seen a marked increase in shareholder proposals seeking an annual advisory vote on a company's executive compensation program (the so-called "Say on Pay"). With many foreign companies now routinely including these advisory votes on their annual shareholder meeting agenda, ISS has developed a standard policy for evaluating an executive pay program for purposes of this vote.

While voting recommendations will be made on a case-by-case basis, ISS has indicated that its assessment of a U.S. company's proposal seeking shareholder ratification of its pay program will be guided by both its standard global compensation program principles, as well as a series of guidelines specific to U.S. companies. Generally, ISS may recommend an "against" vote where a company is seeking ratification of its executive compensation program if, in its view, the board of directors has "failed to demonstrate good stewardship of investors' interests regarding executive compensation practices."

For this purpose, "good stewardship" will be evaluated against the following global principles that ISS believes should be followed by all companies (both foreign and U.S.):

- Maintain an appropriate pay-for-performance alignment (taking into consideration the link between pay and performance, the fixed versus variable pay mix, the use of appropriate performance metrics, and the cost of equity-based compensation) with emphasis on long-term shareholder value

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- Avoid arrangements that risk "pay for failure" (such as indefinite employment agreements, excessive severance packages, and guaranteed compensation)
- Maintain an independent and effective compensation committee (for example, a committee that includes directors with the appropriate skills, knowledge, and experience, and that uses a sound decision-making process – including access to independent expertise and advice when needed)
- Provide shareholders with clear, comprehensive compensation disclosure
- Avoid inappropriate pay to non-executive directors that would compromise their independence and ability to make appropriate judgments in overseeing executive pay and performance

In the case of U.S. companies, several additional factors also may be considered in determining "good stewardship" (in the context of each company's specific circumstances and its board of directors' rationale for its practices):

Relative Considerations:

- An assessment of the program's performance metrics relative to business strategy, as discussed and explained in the company's Compensation Discussion and Analysis
- An evaluation of the peer group or groups used to set target pay or award opportunities
- The alignment of company performance and executive pay trends over time
- An assessment of the difference between the total pay of the CEO and the other named executive officers

Design Considerations:

- The balance of fixed versus performance-based pay
- An assessment of "excessive" pay practices with respect to perquisites, severance arrangements, supplemental executive retirement plans, and equity burn rates

Communication Considerations:

- An evaluation of the information and board of directors' rationale provided in the company's Compensation Discussion and Analysis about how compensation is determined (for example, why certain pay elements and performance targets are used, and specific incentive plan goals, especially where the performance period has been completed)
- An assessment of the board's responsiveness to investor input and engagement on compensation issues (for example, in responding to majority-supported shareholder proposals on executive pay matters)

While ISS believes that the first set of management-initiated advisory votes on executive compensation programs will begin to appear this year, it's likely that most, if not all, of these votes are at least two years away. Still, understanding ISS' criteria in formulating voting recommendations on these ratification requests will be helpful to companies that are beginning to draft their executive pay disclosure with this objective in mind.

Burn Rate Tables

Each year, ISS updates its "burn rate" tables and limits for the upcoming proxy season. "Burn rate" is measured using the total number of equity awards (stock and options) granted in a given year and is expressed as a percentage of the number of common shares outstanding. These tables set the acceptable burn rate levels (based on one standard deviation above the industry mean) using global industry classification standard (GICS) codes.

Currently, ISS will issue an "against" recommendation for an equity plan proposal if the company's average three-year burn rate exceeds one standard deviation higher than the industry mean (based on the applica-

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ble GICS category), *and* is greater than 2%. If a company grants both full value awards and stock options, ISS applies a "multiplier" to the full value awards for the past three fiscal years to equate them economically with stock options. A company that would otherwise fail the burn rate test may still avoid an "against" recommendation if it publicly commits to stay within its applicable burn rate limit for the next three years.

Changes for 2008

ISS has made two adjustments to these practices for the 2008 proxy season. First, in determining the average three-year burn rate, it will use the weighted average common shares outstanding rather than the fiscal year-end figure in the calculation. This will better account for the impact on a company that has seen a significant change in its number of outstanding shares during the year, either through stock buybacks or stock issuances.

Second, to provide a more gradual distribution for full-value shares on a converted basis based on each company's actual volatility, the number of brackets for determining the "multiplier" for full value shares has been doubled, from three to six:

Annual Stock Price Volatility	Multiplier
54.6% and higher	1 full-value award will count as 1.5 option shares
36.1% or higher and less than 54.6%	1 full-value award will count as 2.0 option shares
24.9% or higher and less than 36.1%	1 full-value award will count as 2.5 option shares
16.5% or higher and less than 24.9%	1 full-value award will count as 3.0 option shares
7.9% or higher and less than 16.5%	1 full-value award will count as 3.5 option shares
Less than 7.9%	1 full-value award will count as 4.0 option shares

Impact of Changes

Companies that have developed a share budget for their equity program based on ISS' pre-2008 burn rate formula should review the new multipliers against their revised burn rate threshold to see whether the changes will have any impact on them. Companies with stock price volatilities between 8% and 25% are likely to find that their burn rate goes down. On the other hand, companies with volatilities between 25% and 36% may see their burn rates increase. Companies with volatilities of 40% or more (a category that includes many high-technology companies) are likely to find the impact of the ISS' changes will not be significant. Companies that manage their share budget to the ISS burn rate levels should note, however, that ISS uses a 200-day stock price volatility figure, and not the company's reported volatility (which is frequently calculated over a longer time frame), in applying its burn rate multiplier. For many companies, this 200-day calculation will result in a different (possibly lower) volatility figure and (possibly higher) multiplier.

ISS has also updated its burn rate limits for each different industry classification. Generally, these limits will increase for the 2008 proxy season, in part due to the new refined burn rate multiplier structure.

Stock Option Overhang Cost

ISS uses a cost-based analysis to assess the amount of shareholder equity that will be transferred from a company to its employees under a proposed equity plan. The "cost" of an equity plan is expressed in terms of the "shareholder value transfer" (SVT), which is measured using a binomial option pricing model that assesses the amount of shareholders' equity flowing out of the company to plan participants as stock options are exercised and/or restrictions on other stock awards lapse.

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ISS Issues Policy Updates for 2008 Proxy Season (continued)

When analyzing the cost of a new equity plan (or an amendment to add shares to an existing plan), ISS determines the total cost of a company's equity compensation program, looking at the new shares being reserved, shares available under all existing equity compensation plans, and shares subject to outstanding awards (the so-called "overhang"), expressed as a percentage of the company's market capitalization. This total cost or SVT is then compared to a company-specific cap that is both industry and performance-based. (These company-specific caps are proprietary and not generally published; a company wishing to verify whether it satisfies the ISS standard must engage the firm for this purpose.)

Changes for 2008

Recognizing that strong-performing companies where employees hold on to their stock option grants for several years may be adversely affected by the cost of their "overhang" attributable to these options, ISS has adopted a new policy for companies with sustained positive stock performance and high overhang cost attributable to "in-the-money options" that have been outstanding for more than six years. These companies may receive a carve-out of these options from their overhang as long as the dilution attributable to the new share request is reasonable and the company maintains sound compensation practices.

Specifically, ISS will base its decisions on whether to provide a carve-out of a portion of the company's overhang cost on the following criteria:

- **Performance:** Companies with a sustained positive stock performance (which may be measured on five-year total shareholder return, year-over-year performance, and peer performance) will be eligible for the carve-out
- **Overhang Disclosure:** Companies seeking the carve-out will need to provide additional disclosure (essentially highlighting the number of "in-the-money" options outstanding in excess of six years and related information about these options, including the number held by named executive officers) to enable ISS to adjust its computations for the carve-out
- **Dilution:** ISS will calculate how long the new share request (together with all shares still available for issuance) will last using the company's average unadjusted (options and full value awards accounted on a one-for-one basis) burn rate over the past three years (or a burn rate commitment made for future years). Simply put, this calculation is based on the total size of the projected share pool divided by the average number of shares granted over the past three years. If the expected duration of the share pool exceeds five years, the company may not qualify for the carve-out
- **Compensation Practices:** ISS will evaluate the company's overall grant practices, including stock option repricing provisions (if any), a high concentration of awards to top executives, or the presence of poor pay practices (as identified below)

Impact of Changes

Companies with significant numbers of outstanding stock options should review their option profile well in advance of their annual shareholder meeting to determine whether they will be able to take advantage of this option carve-out.

Poor Pay Practices

For the past three years, ISS has been identifying what it considers to be "poor pay practices," the presence of which may result in a "withhold vote" or "against" recommendation for directors (particularly, the CEO and the compensation committee members) who are up for reelection, or an equity plan that is viewed as facilitating such practices. As a practical matter, ISS evaluates companies on a case-by-case basis, so the existence of what it considers to be an egregious pay practice will not automatically led to a negative vote recommendation. However, companies that have experienced difficulties with ISS need to be sensitive to its position on these pay practices to minimize potential future problems.

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ISS Issues Policy Updates for 2008 Proxy Season (continued)

While initially there was widespread concern that the introduction of the new Compensation Discussion and Analysis would prompt ISS to dramatically revise its list of poor pay practices for the 2008 proxy season, which has not happened. Instead, ISS simply clarified the policy in several respects:

- It may recommend a "withhold" or "against" vote in situations where a company has been previously warned about a poor pay practice, but has taken no action to remedy the practice (this will not apply where the company is contractually obligated to observe the practice)
- The examples of poor pay practices have been expanded to include multi-year base salary increases that are guaranteed as part of an employment agreement, and perquisites for former executives such as car allowances, personal use of corporate aircraft, or other inappropriate arrangements
- A new category of "poor disclosure" has been added
- Base salary will now be used as a relative measure to determine if certain perquisites are excessive

Consequently, the updated list of poor pay practices (which is not exhaustive) that may warrant a "withhold vote" recommendation is as follows:

- Excessive employment agreements (for example, agreements that contain multi-year guarantees for salary increases, bonuses, and equity awards)
- Excessive perquisites (for example, overly-generous cost and/or reimbursement of taxes for personal use of corporate aircraft, personal security systems maintenance and/or installation, car allowances, and/or other excessive arrangements relative to base salary)
- Abnormally large bonus payouts without a justifiable performance linkage or proper disclosure
- Performance metrics that are changed, canceled, or replaced during the performance period without an adequate explanation of the reason for the action and the link to performance
- Egregious pension or supplemental executive retirement plan payouts (for example, the inclusion of additional years of service credit not earned that result in significant payouts or the inclusion of performance-based equity awards in the pension calculation formula)
- A new CEO with an overly-generous compensation package (including, for example, excessive "make whole" provisions or any of the other examples of poor pay practices)
- Excessive severance or change-in-control provisions (for example, the inclusion of payments with a multiplier in excess of 3X cash compensation, severance paid for a "performance-related" termination, "single trigger" change-in-control payments (for example, payments that are awarded without the loss of a job or a substantial diminution of job duties), and perquisites for former executives, such as car allowances, personal use of corporate aircraft, or other inappropriate arrangements)
- Internal pay disparity (an excessive differential between CEO total pay and that of next highest paid named executive officer)
- Stock option backdating

In addition, this area now covers poor compensation disclosure practices, including:

- An unclear explanation of how the CEO is involved in the compensation-setting process
- A failure to discuss the performance targets and award methodology for annual and long-term incentive awards where the performance period has been completed
- A failure to disclose and explain a company's methodology for benchmarking practices and/or its compensation peer group

Undoubtedly, this list will grow as ISS gains more experience in evaluating companies' compensation disclosures.

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Good Pay Practices

In addition to what it doesn't like, ISS has also begun to identify the types of compensation practices that it believes companies should use in their executive compensation programs (although, in reality, these "good" practices tend to be framed in the negative – essentially telling a company what it shouldn't do). These practices reflect its overarching belief that executive pay should be fair, competitive, reasonable, and appropriate, as well as fundamentally performance-based.

- **Employment agreements:** These should be limited to new executives and have a limited duration (for example, three years). They should not have an automatic renewal feature and should have a specified termination date.
- **Severance agreements:** These should not be so appealing that they serve as an incentive for the executive to be terminated. Severance arrangements should exclude excise tax gross-ups, the severance formula should be reasonable and not overly-generous (for example, severance multiples should be between 1X and 3X, and should use pro-rated target/average historical bonus and not the maximum bonus amount), and a failure to renew an employment agreement, termination under questionable circumstances, or termination for poor performance should not constitute a basis for severance payments.
- **Change-in-control payments:** These should only be made when there is a significant change in a company's ownership structure, and when there is a loss of employment or a substantial change in job duties associated with the transaction (a "double trigger" arrangement). Further, these payments should exclude excise tax gross-ups and should not provide for accelerated vesting of equity awards except under a "double trigger" scenario.
- **Supplemental executive retirement plans:** Provisions that can increase the SERP value significantly or even exponentially, such as additional years of credited service or the inclusion of variable pay (for example, bonuses and equity awards) in the benefits calculation formula should be avoided. Similarly, pension formulas should not make use of extraordinary annual bonuses paid close to retirement years or the maximum level of compensation earned.
- **Deferred compensation:** Above-market returns or guaranteed minimum returns should not be applied on deferred compensation.

In the area of compensation disclosure practices, ISS indicates that the Compensation Discussion and Analysis should be written in plain English, and formatted using section headers, bulleted lists, tables, and charts to make the discussion easier to understand. Further, the CD&A should provide the detail and rationale regarding compensation amounts, pay strategy, the pay mix, performance-based compensation metrics and targets, competitive positioning and analysis, and the link between pay and performance.

It will be difficult to predict how much of an impact the quality of a company's executive compensation disclosure is likely to have on ISS' recommendations in 2008. Like most of the other items covered in this policy, whether a practice is "good" or "poor" is almost entirely within the discretion of the ISS analyst. Further, it is unclear whether ISS intends to be lenient with companies this year given the relative newness of the CD&A. If past experience is an indicator, each company's compensation and disclosure practices will have to be evaluated on their own facts. Consequently, it may take some time to develop a sense of what will pass muster and what will result in an adverse vote recommendation

Implications of Updated Policies

ISS continues to be a strong presence in the proxy voting area, and, for many companies, its policies are very influential with their investors. Typically, companies with strong institutional shareholder bases try to design their executive compensation programs to

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avoid "against" or "withhold" vote recommendations. While the policies offer insight into ISS's position on current executive pay issues, they are not always an accurate forecast of its ultimate analysis or vote recommendations for an individual company. While this year's compensation-related updates are less extensive than in prior year's, the incorporation of disclosure practices into the policies create some uncertainty about the impact a company's 2007 compensation disclosures will have on 2008 voting recommendations. While the new disclosure requirements present an opportunity for companies to better explain how their programs work to audiences such as ISS, it remains to be seen whether companies and investors can find common ground on how a pay-for-performance compensation philosophy should be implemented. ◆

To obtain a copy of the ISS Governance Services US Corporate Governance Policy 2008 Updates," please click here.

About Compensia

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management. Formed in 2003 by a group of leading executive compensation experts with more than 60 years of experience, our mission is to offer Thoughtful Pay™ solutions in an ever-changing executive compensation landscape.

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