ISS Issues Policy Updates for 2011 Proxy Season

Institutional Shareholder Services, the prominent corporate governance advisory services firm, has updated its U.S. corporate governance policies for 2011. This latest annual update addresses, among other things, the corporate governance and executive compensation policies that ISS will use to determine its voting recommendations for its proxy advisory clients during the upcoming 2011 proxy season.

As expected, the policy updates focus on the new shareholder advisory votes on executive compensation that are mandated in 2011 by the Dodd-Frank Wall Street Reform and Consumer Protection Act. In addition the updates include refinements to ISS' existing burn rate and problematic pay practices policies. However, updated burn rate tables for 2011 won't be available until later this month.

The updated policies are effective for shareholder meetings held after February 1, 2011.

Significance of Policies

As a long-time advisor to the institutional investor community, ISS has established itself as a bellwether for the key shareholder issues to be addressed each proxy season. ISS regularly publishes annual updates to its standards on good corporate governance and executive compensation policies and practices. These standards, which are contained in a series of policy statements, including a comprehensive "Executive Compensation Evaluation" policy statement, are used by ISS to formulate the voting recommendations that it provides to its clients for the election of directors and other proposals submitted for shareholder action at annual shareholders' meetings, as well as to analyze companies' corporate governance and executive compensation policies and practices.

While most technology and life sciences companies focus on the policy updates that affect their corporate governance structure and executive compensation programs, the updates actually encompass a broader range of social and environmental issues.

This article summarizes the policy updates for 2011 that affect executive and equity compensation matters.

Comprehensive Policy Statement

In 2010, ISS integrated its then-existing compensation-related policy statements into a single, comprehensive

Four Things Technology and Life Sciences Companies Should Know About the 2011 Policy Updates

- In most instances, failing an ISS executive compensation evaluation because of the presence of one or more "problematic" pay practices will first result in a negative vote recommendation on a "Say on Pay" resolution and, only if a "Say on Pay" vote is not being conducted, will lead to an unfavorable vote recommendation for compensation committee members.
- ISS is recommending that companies conduct their "Say on Pay" votes on an annual basis.
- ISS has scaled back the list of "problematic" pay practices that, on a stand-alone basis, may lead to a negative vote on a "Say on Pay" resolution and/or an unfavorable vote recommendation for directors to just the following items: a non-shareholder-approved stock option repricing (or exchange or buyout), excessive perquisites or tax gross-ups, and new or extended employment or severance agreements that provide for excessive change-in-control payments (that is, payments that exceed three times base salary and average/target/most recent bonus) or contain a "problematic" feature.
- Effective immediately, ISS will no longer consider prospective commitments to change "problematic" pay practices in rendering or reversing a vote recommendation (other than in the case of burn rate or "pay-for-performance" commitments).

"Executive Compensation Evaluation" policy. Not only did this integration eliminate the overlap that existed between several of these policies, it also created an ordered system for the application of ISS' voting recommendations on executive compensation matters.

Under this policy, ISS will apply its compensation-related voting recommendation to the following ballot items in the order indicated:

- Shareholder advisory votes on executive compensation;
- The election of directors (primarily compensation committee members); and
- Equity plan proposals (either new plans or the addition of shares to existing plans).

Generally, where a company conducts a shareholder advisory vote on its executive compensation program ("Say on Pay") at its annual shareholders' meeting, which will be the case for all public companies in 2011, ISS will first apply its recommendation to that item. Where an egregious pay practice is identified, or when no "Say on Pay" resolution is on the ballot, or where a company has failed to respond to concerns raised in prior "Say on Pay" evaluations, then ISS will recommend a "withhold" or "against" vote on compensation committee members (or, in rare cases where the full board of directors is deemed responsible, all directors, including the CEO).

Observations. The use of a single, integrated compensation policy has made it somewhat easier for companies to understand and respond to ISS' various policy positions. Further, ISS' process for prioritizing client concerns (which is an outgrowth of its expanded annual policy survey) has helped clarify which issues have the greatest practical consequences for companies. While ISS does not concede that a "problematic" pay practice will not have any implications on its voting recommendations, it is potentially helpful to know which issues will trigger a "withhold" or "against" vote recommendation on a stand-alone basis and which will not.

With the advent of the new mandatory "Say on Pay" vote requirement, this will now become the centerpiece of the ISS analysis and should provide some additional comfort to companies concerned that some unforeseen aspect of their executive compensation program could lead to an unexpected vote recommendation against their compensation committee members. Over the long-term, this approach could lead to a large number of companies conducting "Say on Pay" votes every year, rather than biennially or triennially, as permitted.

Say on Pay Voting Frequency

In addition to the "Say on Pay" vote itself, in 2011 companies will be required to solicit the views of their shareholders on the frequency of future "Say on Pay" votes and, thereafter, at least once every six years. ISS intends to recommend to its clients that they seek annual "Say on Pay" votes.

Observations. ISS' position on the frequency of "Say on Pay" votes is not a surprise. Based on its long-standing support for shareholder advisory votes on executive compensation, ISS clearly views the "Say on Pay" vote as an important mechanism for shareholders to communicate their views on an executive compensation program to a company on an ongoing basis.

Given that the frequency vote is advisory only, and, thus, is not binding on a company and its board of directors, it is unclear how ISS will respond if a company chooses to ignore the plurality of votes cast and conducts future "Say on Pay" votes on a different schedule than that favored by the plurality. At this stage, ISS is waiting to see how the 2011 proxy season unfolds before developing a policy position on this question. Nonetheless, we would not be surprised if it takes the position that it will recommend a "withhold" or "against" vote for the members of a compensation committee (and, potentially, the entire board of directors) where a plurality of the votes cast favor an annual "Say on Pay" vote, but the company adopts a biennial or triennial vote policy.

"Golden Parachute" Compensation Voting

As required by the Dodd-Frank Act, a company that solicits the approval of its shareholders for a merger, acquisition, or other extraordinary corporate transaction must provide disclosure about any compensation payable to its named executive officers (or the named executive officers of the acquiring entity if the soliciting company is not the acquiring entity) that is based on or relates to the merger or other transaction and conduct a separate shareholder advisory vote on such compensation arrangements (unless they have previously been subject to a "Say on Pay" vote).

ISS intends to evaluate these advisory vote resolutions on a case-by-case basis, but has indicated that certain prac-

tices and/or arrangements may lead to an "against" vote recommendation:

- Recently adopted or materially amended agreements that include excise tax gross-up provisions (since the prior annual meeting of shareholders). ISS defines a "modified single trigger" as an arrangements under which an executive my voluntarily leave for any reason and still receive a change-in-control severance package;
- Recently adopted or materially amended agreements that include modified "single triggers" (since the prior annual meeting of shareholders);
- "Single-trigger" payments that will happen immediately upon a change in control, including cash payment and such items as the acceleration of performance-based equity despite the failure to achieve performance measures;
- "Single-trigger" vesting of equity based on a definition of change in control that requires only shareholder approval of the transaction (rather than consummation of the transaction);
- Potentially excessive severance payments (for example, a cash severance payment that exceeds three times base salary and average/target/most recent bonus);
- Recent amendments or other changes that may make packages so attractive as to influence merger agreements that may not be in the best interests of shareholders;
- In the case of a substantial gross-up from a pre-existing or grandfathered contract: the element that triggered the gross-up (that is, option mega-grants at a low point in stock price, unusual or outsized payments in cash or equity made or negotiated prior to the merger); or
- The company's assertion that a proposed transaction is conditioned on shareholder approval of the "golden parachute" compensation advisory vote (which ISS will view as a "problematic" pay practice from a corporate governance perspective).

In situations where a company seeks to have its change-in-control arrangements considered by its shareholders as part of its "Say-on-Pay" vote, ISS will evaluate the "Say-on-Pay" resolution in accordance with these guidelines, which may give greater weight to this aspect of the executive compensation program in its overall evaluation.

Observations. Few, if any, of the enumerated change-in-control features or practices should come as a surprise, as they are wholly consistent with ISS' "problematic" pay practices in the post-employment compensation area. To the extent that they are based on ISS' subjective evaluation (for example, an amendment to a compensation package that triggers a merger that is not in the best interests of shareholders); however, it may take some actual experience with the new policy before we develop a feel for how ISS intends to apply this standard.

We don't expect many companies to avail themselves of the exception to the shareholder advisory vote on "golden parachute" compensation; largely because of the extensive disclosure requirements that must be satisfied to take advantage of the exception. Nonetheless, ISS' decision to evaluate the change-in-control provisions of an executive compensation program under these new guidelines and, potentially, base its vote recommendation for the "Say on Pay" resolution largely (if not solely) on its assessment of these provisions almost certainly will restrict the exception's use to the most narrow circumstances. Thus, this policy should have limited impact on most companies, unless they find themselves a party to a pending acquisition transaction.

Burn Rate Policy

Each year, ISS updates its "burn rate" tables and allowable limits for the upcoming proxy season. This year's updated tables will be published later this month. "Burn rate" is measured using the total number of equity grants (stock and options) awarded 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 recommend a vote "against" an equity plan proposal if the company's average three-year burn rate exceeds the greater of:

- the mean plus one standard deviation of the company's GICS peer group segmented on the basis of whether or not it is in the Russell 3000; or
- two percent of the company's weighted common shares outstanding.

In addition, If a company grants both full value awards and stock options, ISS applies a premium or "multiplier" to the full value awards for the past three fiscal years to equate them economically with stock options.

Under its updated policy guidelines, year-over-year burn rate cap changes will be limited to a maximum of two percentage points (plus or minus) the prior year's burn rate cap.

Observations. Based on recent history, this change is unlikely to have much impact on technology and life sciences companies. For example, in 2010, the year-over-year burn rate cap changes for the Russell 3000 GICS code groupings averaged less than two percent each. Even among the non-Russell 3000 GICS code groupings, only four (including software) saw changes in excess of two percent. Thus, absent other factors, few companies are likely to see this policy come into play in 2011.

Problematic Pay Practices

For several years, ISS has identified what it considers to be "poor pay practices," the presence of which may result in a "withhold" or "against" vote recommendation for directors (particularly, a CEO who serves as a director and compensation committee members) who are up for re-election. Under its Executive Compensation Evaluation policy, companies are evaluated on a case-by-case basis for "egregious pay practices" that may lead to a negative vote recommendation as follows:

- Initially, against a "Say on Pay" resolution (assuming one is being submitted for shareholder action);
- "Withhold vote" or "against" compensation committee members (or, in instances where the entire board of directors is deemed responsible for the practice, all directors, including the CEO) in egregious situations, or when no "Say on Pay" resolution is on the ballot, or when the board has failed to respond to concerns raised in prior "Say on Pay" evaluations; and
- Against an equity plan proposal if excessive non-performance-based equity awards are the major contributor to a pay-for-performance misalignment.

While ISS typically bases its vote recommendation on the presence of multiple "problematic" pay practices, the following non-exclusive list represents adverse compensation practices that may, on a stand-alone basis, result in a negative vote recommendation:

- Repricing or replacing of underwater stock options or stock appreciation rights without prior shareholder approval (including cash buyouts and voluntary surrender of "underwater" options);
- Excessive perquisites or tax gross-ups, including any gross-up related to a secular trust or restricted stock vesting; and
- New or extended agreements that provide for change-in-control payments exceeding three times base salary and average/target/most recent bonus, change-in-control severance payments without involuntary job loss or substantial diminution of duties ("single" or "modified single" triggers"), or change-in-control payments with excise tax gross-up (including "modified" gross-ups).

Observations. The reduction in the list of "problematic" pay practices that will, on a stand-alone basis, lead to a negative vote recommendation on a "Say on Pay" resolution or a "withhold" or "against" vote recommendation for compensation committee members is welcome news. The length of prior years' lists of "problematic" pay practices left companies with little guidance as to which program features were viewed as sufficient, on their own, to warrant a negative vote recommendation.

Even with these changes, ISS' "problematic" pay practices will continue to have a significant impact on whether it is willing to support a "Say on Pay" resolution or the re-election of a company's directors (particularly compensation committee members) and equity plan proposals. Companies should review their existing executive compensation arrangements in light of this new list (as well as the broader list of "problematic" pay practices) to identify any potentially troublesome program features. For example, companies with severance arrangements that contain a modified "single-trigger" provision or allow accelerated vesting of outstanding equity awards even where a proposed change-in-control transaction is not consummated may want to re-evaluate the merits of such provisions.

Problematic Pay Practices – Commitments

In prior years, when ISS has identified a "problematic" pay practice, it has often foregone issuing a negative vote recommendation where a company has committed to eliminate the practice prospectively.

ISS Issues Policy Updates for 2011 Proxy Season (continued)

Effective from November 19, 2010, ISS will no longer consider prospective commitments to change "problematic" pay practices in rendering or reversing a vote recommendation. Accordingly, prospective commitments to eliminate or curtail the following practices will no longer be considered in ISS' evaluations:

- Excise tax gross-up, "single-trigger," and "modified single-trigger" provisions in future new or materially amended employment agreements;
- Excessive perquisites, including home loss buyouts and other perquisites compensation to named executive officers that is deemed excessive;
- Tax gross-ups on perquisites, such as for life insurance, personal use of corporate aircraft, home security, and certain relocation benefits, as well as gross-ups for secular trusts and restricted stock vesting;
- Guaranteed multi-year incentive awards; or
- Dividend payments on unvested performance shares

There are two notable exceptions, however, to this policy change:

- "Pay-for-performance" and burn rate commitments, since ISS' burn-rate caps and total shareholder return benchmarks that apply to each compensation year are not disclosed until late in the year, after a company may have made awards that ultimately trigger the relevant ISS policy; and
- Plan language related to certain equity grant practices (for example, a liberal change-in-control definition), which may be modified under a straightforward procedure so that a plan that is then more beneficial to shareholders may receive a favorable recommendation from ISS.

Observations. ISS' "get tough" approach is based on its belief that, after several years of publicizing its policy updates, companies should be sufficiently familiar with its compensation standards and expectations. Consequently, companies will no longer be able to wait until ISS, having identified a specific "problematic" pay practice, is threatening a negative vote recommendation before changing the practice. In this regard, this "commitment" policy was really just a transitional mechanism while companies became familiar with ISS' evolving policy guidelines.

Citing its "holistic" approach to evaluating an executive compensation program, ISS also appears to be saying that, except as noted previously, most "problematic" pay practices are not likely – in and of themselves – to lead to a negative vote recommendation, particularly where a compensation committee has demonstrated responsible stewardship in its executive compensation actions and decisions. As a practical matter, ISS is encouraging companies to adopt forward-looking policies to address "problematic" pay practices, which will be considered in future reviews of a company's executive compensation program.

Difference in Country of Incorporation and Listing

Previously, ISS applied its benchmark policies based on a company's country of incorporation. Beginning in 2011, however, it intends to apply its U.S. Corporate Governance Policies to companies that are incorporated outside the United States, but which are considered domestic issuers by the Securities and Exchange Commission because they file periodic reports, including proxy statement, under the U.S securities laws.

Observations: While this policy change won't affect most technology and life sciences companies, those that have incorporated outside the United States, or are considering doing so, will be subject to the same corporate governance and executive compensation standards as the other companies in their primary market of operation. This eliminates the advantage (no matter how nominal) that may otherwise have come from ISS" prior position.

Further Guidance Forthcoming

ISS has indicated that it intends to publish an updated summary of its policy guidelines in December and revised Frequently-Asked Questions and Answers on its compensation-related policies by the end of January 2011. Hopefully, this additional guidance will address the open issues and questions that undoubtedly will arise as a result of ISS' new policy positions.

Don't Forget Your GRId Analysis

ISS' analysis under its Goverance Risk Indicators ("GRId") tool is now included in its proxy research reports, which will contain its recommendation on your "Say on Pay" resolution. We can help you verify the accuracy and complete-

ness of the data that ISS has used to establish your company's GRId rating and determine your GRId score in advance using our proprietary model. This information may be helpful in identifying whether any areas of your executive compensation program are viewed as "problematic" by ISS and could potentially affect your "Say on Pay" vote.

Implications of Updated Policies

This year's executive compensation policy updates are significantly more limited than in prior years. ISS foresight in updating its policies for the pending shareholder advisory votes on executive compensation last year minimized the need to make wholesale changes this fall. In fact, the advisory vote-related policy changes reflect unique features in the new law which could not have been anticipated a year ago.

For most companies, the key questions in 2011 will be whether ISS will support their "Say on Pay" resolutions and whether they want to abide by ISS' recommendation for annual "Say on Pay" votes. As to the former issue, ISS' refinement of its Executive Compensation Evaluation policy to scale back the number of potential "red flags" that could, on a stand-alone basis, trigger a negative vote recommendations should make it easier for companies to accurately assess the prospects for their initial "Say on Pay" vote and to determine whether specific executive compensation policies or features need to be modified or eliminated. With respect to the latter issue, next year's initial frequency vote should demonstrate, once and for all, the extent of ISS' influence on corporate governance matters.

As in past years, while the updated policies offer insight into ISS' position on current executive pay issues, they are not always an accurate forecast of its ultimate analysis or vote recommendations for an individual company. The specific issues that companies may encounter will continue to depend on the orientation and experience of the analyst reviewing the company's program, as well as the totality of its corporate governance and executive compensation picture.

Companies with unusual compensation structures or controversial pay policies or practices should use their Compensation Discussion and Analysis as a platform to explain and justify their compensation policies (and related decisions) to ensure that ISS has access to appropriate information with which to formulate its 2011 voting recommendations. ■

To obtain a copy of the ISS "US Corporate Governance Policy – 2011 Updates," click here »

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