

ISS ISSUES 2011 POLICY UPDATES

December 8, 2010

Proxy advisory firm Institutional Shareholder Services Inc. (“ISS”) recently issued its 2011 governance and executive compensation proxy voting policy updates (the “Updates”), effective for shareholder meetings occurring on or after February 1, 2011.¹ Given ISS’ influence in today’s compensation and governance environment, many public companies will want to consider the Updates in evaluating whether aspects of their governance or – in particular – compensation practices should be modified, as companies gear up for the new say on pay requirements mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”). ISS’ major compensation-related policy updates, discussed in more detail below, include the following:

- ISS will recommend a vote for annual say on pay votes, as opposed to votes every two or three years;
- ISS will evaluate say on pay proposals for golden parachute compensation on a case-by-case basis;
- The list of “problematic pay practices,” which ISS considers in formulating its voting recommendation for say on pay votes, has been streamlined; and
- ISS will no longer accept a company’s future commitment to change a problematic pay practice as a means of preventing or reversing a negative vote recommendation.

The remainder of this client alert summarizes key compensation and governance aspects of the Updates.

Executive Compensation

Say on Pay

The Dodd-Frank Act, in addition to requiring non-binding shareholder advisory votes on named executive officer compensation (“say on pay votes”), requires that proxy statements for annual meetings occurring on or after January 21, 2011 include a non-binding advisory vote to determine whether the say on pay vote will be held every one, two or three years.² ISS’ new policy on the say on pay frequency vote will be

¹ The Updates were issued by ISS (formerly RiskMetrics Group) on November 19, 2010 and can be accessed at http://www.issgovernance.com/policy/2011/policy_information. The Updates identify ISS’ benchmark compensation and governance policies and the factors that will affect its proxy voting recommendations.

² Our client alert describing the proposed say on pay rules issued in October 2010 by the Securities and Exchange Commission (the “SEC”) may be found at: <http://www.wcsr.com/resources/pdfs/cs102710b.pdf>. In addition, our client alert discussing other Dodd-Frank Act-related potential compensation and governance action items may be found at: <http://www.wcsr.com/resources/pdfs/cs092010.pdf>. Although a number of proxy advisory and institutional investor firms have not yet announced their policy regarding say on frequency votes, the Council of Institutional Investors has also recommended an annual vote. See <http://www.cii.org/policies>.

to recommend a vote for annual say on pay votes, rather than votes every two or three years. ISS believes that the say on pay vote is in essence a communication vehicle and that communication is most useful when it is received in a consistent and timely manner. For example, in ISS' view, with a triennial say on pay vote, a company would not know whether the say on pay vote reflects shareholder opinion on the compensation being discussed in the current proxy or from a previous year, making it more difficult to understand the implications of the vote. Although 2011 may be a "wild card" year in terms of predicting how companies will fare in the inaugural proxy season of Dodd-Frank required say on pay votes, according to an ISS 2010 proxy season report, the average support for corporate pay practices in 2010 was 89.6 percent, up from 87.4 percent in 2009 (with only three companies failing to receive majority support).³

Golden Parachute Say on Pay Votes

The Dodd-Frank Act also requires that shareholders voting on a merger or other similar transaction be provided with an advisory vote on merger-related compensation agreements ("golden parachutes"), unless the golden parachute arrangements were previously included in the company's general say on pay vote. ISS' new policy on golden parachute say on pay votes will be to evaluate such proposals on a case-by-case basis, consistent with ISS' policies on problematic pay practices related to severance packages. Features that may lead to a recommendation against golden parachute say on pay proposals include:

- Recently adopted or materially amended agreements that include excise tax gross-up provisions or modified single triggers (since the prior annual meeting);
- Single trigger payments that will happen immediately upon a change in control, including cash payments 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 (rather than consummation) of the transaction;
- Potentially excessive severance payments;
- 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, ISS will review the gross-up trigger (e.g., option mega-grants at low point in stock price); or
- The company's assertion that a proposed transaction is conditioned on shareholder approval of the golden parachute advisory vote.

In cases where the golden parachute arrangements are included in the company's general say on pay vote in an annual meeting proxy statement, ISS will evaluate the say on pay proposal in accordance with these guidelines, which may result in greater weight being given to the golden parachute component of the overall compensation program. This may lead companies to elect not to include golden parachute arrangements in an annual meeting proxy statement say on pay proposal unless they are certain that such arrangements conform to ISS' guidelines.

³ ISS 2010 U.S. Postseason Report, available at: <http://www.issgovernance.com/docs/2010USPostSeasonReport> (November 12, 2010).

Problematic Pay Practices

ISS evaluates executive compensation on a case-by-case basis. Where “problematic pay practices” are deemed to exist, ISS will recommend votes:

- Against management say on pay proposals;
- When no say on pay proposal is on the ballot, when the board has failed to respond to concerns raised in prior say on pay votes or in egregious situations, against or withhold on compensation committee members (or, in rare cases, the full board); and/or
- Against an equity-based incentive plan proposal if excessive non-performance based equity awards are the major contributor to a pay-for-performance misalignment.

ISS has now revised the list of egregious pay practices that, by themselves, are sufficiently problematic to warrant withhold or against votes in most circumstances. These practices are:

- Repricing or replacing of underwater stock options/SARs 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-ups (including “modified” gross-ups).

ISS has asserted that it will continue to evaluate compensation on a case-by-case basis; however, the existence of any of these practices alone may trigger a negative recommendation on a say on pay vote. Thus, companies should evaluate their compensation programs now to identify any problematic pay practices. Many companies have already begun to address so-called “problematic” practices. According to ISS, this year, over 220 companies disclosed modifications to “problematic” practices, particularly with respect to change in control practices (e.g., eliminating excise tax gross-ups) and elimination or reduction of perquisites and excise tax gross-ups on perks.⁴

Future Commitments on Problematic Pay Practices

Historically, when ISS has identified a problematic pay practice, it has generally accepted a commitment by the company that it will eliminate such practice going forward, thus precluding a negative vote recommendation. Effective immediately, except in certain limited circumstances, ISS will no longer consider prospective commitments with respect to problematic pay practices in its current recommendation. Thus, companies should thoroughly evaluate their pay practices in light of ISS’ policies in advance of their next proxy statement. Future commitments may still influence some shareholders, but, in most cases, they will not change an ISS recommendation.

⁴ See ISS 2010 U.S. Postseason Report.

Burn Rates

ISS generally votes against equity plans for companies whose average three-year burn rate exceeds the greater of (i) the mean plus one standard deviation of the company's GCIS group segmented by Russell 3000 index and non-Russell 3000 index; and (ii) two percent of weighted common shares outstanding. ISS is now amending that policy to state that year-over-year burn-rate cap changes must be limited to a maximum of two percentage points plus or minus the prior year's burn-rate cap. The rationale for this change is to compensate for both outlier companies within any individual GICS group and the impact of recent market volatility that may result in extraordinary changes in annual burn-rate caps.

Corporate Governance

Common and Preferred Stock Authorizations

ISS has modified the method for determining allowable increases of common and preferred stock authorizations and put increased emphasis on disclosure of not only the uses of, but also the risks of non-approval for, such authorizations.

Director Attendance

ISS will now only "excuse" a failure to meet a 75 percent combined board and committee meeting threshold if the reason for a director's lack of attendance is due to medical issues/illness or family emergencies or if the director only missed one out of a total of three or fewer meetings, but only if the reason for the absence is disclosed in the proxy statement or another SEC filing; private communications with ISS regarding the reasons for nonattendance will no longer be acceptable as a means to explain a failure to meet the threshold. If the public disclosure is not sufficient to determine whether a director met the 75 percent threshold, ISS generally will recommend a vote against the director.

Board Response to Majority-Approved Shareholder Proposals

Under ISS' current policies, ISS will recommend a withhold or against vote for the entire board if the board failed to act on a shareholder proposal that received (i) approval of a majority of the shares outstanding the previous year or (ii) approval of a majority of the shares cast for the past two years. Under the Updates, with respect to the second trigger, ISS will recommend a "no" vote for directors if the board failed to act on a shareholder proposal that received approval of the majority of the votes cast in the last year and one of the two previous years (rather than two consecutive years).

Shareholder Action by Written Consent

Current ISS policy calls for (i) a vote against management and shareholder proposals to restrict shareholders' ability to act by written consent, and (ii) votes for such proposals that give shareholders the ability to act by written consent, taking into account certain specified factors. Under the Updates, in connection with (ii), ISS also will consider the company's overall governance practices and takeover defenses and will vote case-by-case on shareholder proposals to allow action by consent if, in addition to the current factors, the company has no non-shareholder approved poison pill and has implemented the following shareholder-protective provisions: majority voting in uncontested directors elections, annual board elections and an "unfettered" right for shareholders to call special meetings at a 10 percent threshold.

Conclusion; Contact Information

Boards of directors must be guided by their fiduciary duty to act in the best interests of the company and its shareholders when making compensation and governance decisions and, although the proxy voting guidelines of ISS and other firms certainly may be relevant in a company's analysis, companies should not be blindly guided by such policies. Nonetheless, particularly because most companies will hold their first say on pay votes in the 2011 proxy season, the new ISS compensation policies may be especially relevant.⁵ To the extent that problematic pay practices can be corrected, the time to act is now since future commitments will no longer impact ISS' recommendation. To the extent that they cannot be corrected, a company may need to step up its communications with shareholders to counteract a potentially negative ISS voting recommendation and should be prepared to preemptively discuss in their proxy materials why the company feels that such so-called "problematic" practices are in the company's best interests.

If you have any questions regarding the Updates, please contact Meredith Burbank (<http://www.wcsr.com/MeredithBurbank>), the principal drafter of this client alert, or you may contact the Womble Carlyle attorney with whom you usually work or one of our Corporate and Securities attorneys at the following link: <http://www.wcsr.com/profSearch?team=corporateandsecurities>.

Womble Carlyle client alerts are intended to provide general information about significant legal developments and should not be construed as legal advice regarding any specific facts and circumstances, nor should they be construed as advertisements for legal services.

IRS CIRCULAR 230 NOTICE: To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. tax advice contained in this communication (or in any attachment) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed in this communication (or in any attachment).

⁵ Compensation practices are also an important component of a company's GRId rating, which is ISS' new corporate governance rating metric. Please see our earlier client alert describing the GRId system, accessible at <http://www.wcsr.com/resources/pdfs/cs020910.pdf>.