

New ISS Policy Update: Tougher Standards for 2011

On Friday, November 19, ISS Corporate Governance Services released its U.S. Corporate Governance Policy Updates on voting recommendations for meetings occurring on or after February 1, 2011. The updates reflect a number of new or changed policies, most of which slant in the same direction: tighter shareholder-level oversight of executive compensation, and a willingness, perhaps even an eagerness, to use the say-on-pay tools mandated by the Dodd-Frank Act as a lever to effect change. Significant updates include:

- Recommending that companies seek say-on-pay annually, rather than every two or three years;
- No longer allowing companies to make future commitments to modify certain pay practices in order to reverse unfavorable recommendations;
- Revising the list of “egregious” pay practices that, by themselves, are sufficiently problematic to warrant negative compensation-related recommendations, including negative say-on-pay or compensation committee recommendations;
- Amending the calculation of allowable increases on common and preferred stock authorizations; and
- Limiting net operating loss protective amendments and pills to three-year terms.

Companies should review these updates now against their executive compensation practices, and any management or shareholder proposals that may be included on the proxy card.

Executive Compensation Updates

Annual say-on-pay.

No surprise here: ISS prefers annual say-on-pay votes, and the policy provides no indication that ISS will entertain any company’s argument to the contrary. Like many shareholder activists, ISS believes that annual say-on-pay provides the highest level of accountability and direct communication. The policy statement argues that providing the vote every two or three years would make for unclear shareholder feedback, because companies would not know which compensation year the vote outcome relates to. The thinking here is characteristically dogmatic and unnuanced, but at least companies will know that if they want to advocate something other than an annual vote they should take their case directly to their shareholders instead of trying to persuade ISS.

Remember, though, that the frequency vote is nonbinding. What happens if a board decides to proceed with something other than an annual vote after 2011, against the preference of a plurality of its shareholders? Will ISS recommend withhold or against votes for director elections? The policy is silent on this question, probably because this will not be an issue until the 2012 proxy season. However, under the proposed SEC rules on say-on-pay, companies will need to disclose their future frequency policy in the Form 10-Q or Form 10-K during the period in which the 2011 meeting occurred. So companies who announce that they are not following the “advisory” vote may be doing so at their peril.

Stand-alone problematic pay practices could lead to negative say-on-pay recommendations.

ISS has modified its definition of “egregious” pay practices: those that by themselves, without regard to a company’s overall executive compensation, could trigger an unfavorable compensation-related recommendation. These include:

- Repricing or replacing underwater stock options or stock appreciation rights without shareholder approval;
- “Excessive” perquisites or tax-gross ups; and
- Entering into new, or extending the terms of existing, agreements that provide for:
 - change in control payments of more than three times the employee's base salary plus average/target/most recent bonus;
 - single trigger change in control payments (*i.e.*, severance payments without involuntary job loss or substantial diminution in his/her duties); or
 - change in control payments with excise tax gross-ups (including “modified” gross-ups).

ISS has allowed itself some wiggle room. It says that it will continue to evaluate programs on a case-by-case basis in the context of a company's overall pay program and past actions. But the policy puts companies on notice that, for example, a minimal amount of a gross-up on an executive perk alone, without other problematic areas, could lead to a negative recommendation on:

- Say-on-pay;
- Compensation committee members (or the entire board if they are responsible) in (a) egregious situations; (b) where no say-on-pay is on the ballot¹ or (c) when the board has failed to respond to concerns raised in prior say-on-pay evaluations; and/or
- An equity incentive plan proposal if excessive non-performance-based equity awards are the major contributors to the pay-for-performance misalignment.

We believe that this policy change, coupled with the elimination of the ability to make future commitments in order to thwart negative recommendations, will increase the percentage of companies that receive negative say-on-pay recommendations from ISS. But a negative ISS recommendation is far from dispositive. In 2010, ISS recommended against say-on-pay at 43 of the 299 companies it evaluated, but only three companies received less than majority support and the average result was 89.6% in favor. In any event the policy update reinforces the need for companies to carefully examine whether their pay actions include practices that ISS deems “problematic.”

Future commitments on pay will not change negative recommendations.

ISS's practice until now has at times been to grant absolution in exchange for repentance. For example, a recommendation against the compensation committee for providing a gross-up on an executive perk could be reversed if the company committed not to provide any gross-ups on executive perks in the future. Companies have been required to make these commitments public, usually by filing additional soliciting materials or a Form 8-K.

ISS says that it is now out of the indulgence business, and that it will no longer accept commitments as to future behavior in order to obtain a favorable recommendation. Its rationale is that its policies are open and notorious, so companies should be aware of them and that a negative recommendation should not be required as a wake-up call. The policy also notes that the speed with which compensation committees

¹ Note the connection with the frequency vote. ISS is saying that if say-on-pay is not on the ballot then, like a heat-seeking missile looking for something warm to aim at, it may recommend against compensation committee members. This suggests another argument for an annual vote: if shareholders are looking for a way to vent, perhaps better to do so through a mechanism like say-on-pay.

agree to these commitments, often within days after the draft report is provided or a final report is published, calls into question the board's process for making compensation changes.

The prospective commitments that will now be disregarded relate not only to the "egregious" practices discussed above, but also to guaranteed multi-year incentive awards and dividend payments on unvested performance shares, with limited exceptions.

Criteria for recommendations on say-on-golden parachute.

Features that may lead to negative recommendations on the new advisory votes on golden parachutes in M&A transactions 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 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);
- 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;
- If a grandfathered gross-up is substantial, ISS will look back to the element that triggered the gross-up to see if it was somehow problematic (e.g., a large option grant made at a time when the company's stock price was depressed, outsized change in control payments); or
- The company's assertion that a proposed transaction is conditioned on shareholder approval of a say-on-golden parachute vote.²

Where the say-on-golden parachutes vote is baked into a regular say-on-pay vote as permitted under proposed SEC rules, ISS will evaluate the say-on-pay proposal in accordance with these guidelines. Since that would cause ISS to scrutinize say-on-pay even more rigorously than otherwise, this creates yet another incentive to not seek an advance vote on say-on-golden parachutes through say-on-pay.

Changes in the burn rate of equity compensation plans to account for market volatility.

ISS will recommend against equity plans where the average three-year burn rate exceeds the greater of:

- the mean plus one standard deviation of the company's GICS group; or
- 2% of the weighted common shares of the company outstanding.

In addition, 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. This policy update is designed to limit the year-over-year change in burn-rate caps within any individual GICS group and the impact of recent market volatility that

² This last factor puts an exclamation point on the absurdity that is the say-on-golden parachute vote. ISS is saying that shareholders could feel coerced into voting in favor of the golden parachutes if a negative vote would have real world consequences such as a merger not going forward. Better, apparently, to preserve the sterility of the exercise by making the vote a purely rhetorical gesture.

may result in extraordinary changes in annual burn-rate caps. ISS will publish an updated burn rate table in December.

Corporate Governance Updates

Reasons for directors missing meetings must be disclosed publicly to affect ISS evaluations.

ISS will generally recommend against the election of individual directors who attended less than 75% of board and committee meetings unless the reasons were related to (a) medical issues or illness; (b) family emergencies; and (c) total service was three meetings or fewer and the director missed only one meeting. In order for ISS to consider whether the reasons for the director absences are valid and do not warrant a recommendation against the director, companies must disclose the explanation for meeting absences in the proxy statement or another SEC filing, removing the previous alternative option of providing those reasons privately to ISS.

Responsiveness to shareholder proposals includes votes cast in two out of three years.

Instead of recommending against the entire board of directors only if the board fails to act on a shareholder proposal that received approval (a) by a majority of the shares outstanding in the prior year or (b) by a majority of the shares cast in the last two years, ISS has amended its policy so that the proposal would need to have received a majority of votes cast in the last year and in one of the two previous years. This is to accommodate a proponent who may have failed to send the same shareholder proposal for two straight years by skipping a year.

Evaluation of shareholder proposals providing for written consent includes additional factors.

In 2010 there were 17 shareholder proposals asking companies to provide shareholders with the ability to act by written consent, and 12 received more than majority support, even when companies had recently adopted bylaw amendments allowing shareholders to call special meetings. We will likely see an increase both in the number of proposals and a rise in support levels in 2011.

ISS generally recommends that shareholders vote for this proposal. Its voting policy on this proposal now also takes into account whether (a) the company provides for an “unfettered” right³ for 10% or more shareholders to call special meetings, (b) majority vote standard, (c) annual board elections and (d) no non-shareholder approved pill. The terms defined by ISS provisions under which shareholders can call special meetings are broader than the ones that most companies have adopted, so this new policy is unlikely to have any meaningful impact on ISS recommendations to generally vote in favor of this proposal.

Net operating loss (NOL) protective amendments and pills limited to three-year terms.

ISS will recommend against a management proposal to approve either an amendment or poison pill to protect a company’s NOL if the term would exceed the shorter of three years and the exhaustion of the NOL.

Application of ISS policies based on country of listing instead of country of incorporation.

ISS will now apply its U.S. policies to companies that are incorporated outside the U.S. but are considered domestic issuers by the SEC and file definitive annual meeting proxy statements and Form

³ Meaning no restrictions on agenda items or the number of shareholders who can group together and limits on when a meeting can be called only for no greater than 30 days after the last annual meeting and 90 days prior to the next annual meeting.

10-Qs and Form 10-Ks. ISS is making the change because in recent years, companies listing on U.S. exchanges have re-incorporated outside the U.S., which then subjected them to non-U.S. policies. This policy update is expected to impact 74 companies.

Capital Restructuring Updates

New methodology for acceptable increase for common and preferred stock authorizations.

ISS has amended its policies related to management proposals to increase the number of shares of authorized common or preferred stock, primarily to clarify its recommendations in specific situations, emphasize the disclosure required and indicate a change in calculation methodology (which will be outlined in an FAQ) that strongly favors an increase of 100% or less of existing authorized capital. The new policy will:

- Recommend in favor of proposals where the primary purpose is to issue common or preferred shares in connection with a transaction on the same ballot that warrants support.
- Recommend against proposals at companies with more than one class of common stock to increase the number of authorized shares of the class that has superior voting rights, or if a vote for a reverse stock split on the same ballot is warranted despite the fact that the authorized common or preferred shares would not be reduced proportionally.
- Examine all other proposals on a case-by-case basis based on factors that include the company's use of authorized common or preferred shares in the past three years, as well as (a) disclosure in the proxy statement of the specific purpose of the increase and specific and severe risks to shareholders of not approving the proposal and (b) the dilutive impact as determined by an allowable cap calculated by ISS that is typically 100% of the existing authorized shares. For a proposal to increase authorized preferred shares, ISS will also examine whether the requested shares are blank check preferred that can be used for antitakeover purposes.

Link requests for reverse stock splits with imminent delisting.

ISS will now recommend voting against management proposals to implement a reverse stock split when there is not a proportionate reduction of authorized shares unless (a) a stock exchange has provided notice to the company of a potential delisting or (b) the effective increase in authorized shares is equal to or less than the allowable increase calculated in accordance with its general policy on share increase authorization. Previously ISS would have recommended a vote in favor of a reverse stock split merely to avoid delisting, without any actual notice received.

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