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EXEQUITY

Independent Board and Management Advisors

Client Alert

ISS's 2011 US Compensation Policy Frequently Asked Questions

On December 14, 2010, Institutional Shareholder Services, Inc. (ISS) released its 2011 US Compensation Policy Frequently Asked Questions (FAQs)[1]. The FAQs address three areas under the ISS 2011 Compensation Policies: frequency of advisory vote on executive compensation; problematic pay practices/commitments on problematic pay practices; and, votes on golden parachutes.

Frequency of Advisory Vote on Executive Compensation

- **Consequence of only biennial or triennial on proxy—**ISS assumes that the SEC proposed rule requiring four choices for the say on pay (SOP) vote frequency vote will be the final rule, and so does not bother to address questions that ask what if only biennial and triennial votes are on the proxy.

- **Consequence of a company's biennial or triennial recommendation—**ISS has no policy with respect to management recommendations of a biennial or triennial SOP vote, and so such company recommendations will **not** trigger negative vote recommendations on other proxy vote items (at least for the 2011 proxy season).

- **When might ISS support a frequency other than annual?—**In response to a question asking in what situations ISS might support a SOP vote frequency other than annual, ISS reiterated that its policy for 2011 is to support **annual** say on pay votes.

- **What if a company fails to implement the SOP frequency supported by the plurality of votes cast?—**ISS does not yet have a policy to address the situation where a company does not adopt the SOP vote frequency that received a plurality of the votes cast. ISS will be working on this policy for 2012.

Exequity Comment: *ISS's FAQs leave quite a few questions unanswered. We expect that ISS policies will continue to develop in regard to SOP frequency votes. We hope that ISS will respect the will of shareholders even if a plurality of votes support a frequency other than annual. However, we'll likely have to wait until next November for the 2012 policy updates to see what ISS decides to do in that situation. As an extreme example, if the frequency came out almost evenly split, with 33% for annual, 34% for biennial and 33% for triennial and a company implements triennial, we hope ISS will respect that decision without any negative consequences.*

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[1] The full text of ISS's FAQs is available at http://www.issgovernance.com/policy/2011/USCompensationFAQ

As of December 21, 2010, 41 companies subject to the new SEC rules have filed either definitive or preliminary proxy statements and the breakdown of their frequency recommendations is: 24 companies have recommended triennial (58.5%), 9 companies have recommended annual (22.0%), 5 companies have recommended biennial (12.2%), and 3 companies have made no recommendation (7.3%)[2]. Clearly, ISS' recommendation to support an annual frequency is not having much of an impact—however, it remains to be seen if this pattern continues for calendar year-end companies

Problematic Pay Practices/Commitments on Problematic Pay Practices

- **Any agreements grandfathered?—**In response to a question asking whether any agreements would be grandfathered under the new 2011 problematic pay practices policy, ISS indicated that all agreements will weigh into its "holistic analysis" of executive pay. But those agreements that help perpetuate problematic pay practices (new and extended agreements) are the most problematic and will receive the highest level of scrutiny.

- **Consequence of Auto-Renewal Agreements with Problematic Pay Practices—**Asked if an automatically renewed agreement that is not otherwise modified would warrant a withhold or against vote recommendation if it contained a problematic pay practice, ISS indicated that automatically renewing/extending agreements (including agreements that do not specify a term) are not considered a best practice and a problematic practice in such an agreement would be a concern. But, if the agreement is not materially amended in a manner contrary to shareholder interests, ISS will evaluate it on a holistic basis along with the company's other compensation practices and features in the existing agreement.

- **Full list of problematic pay practices—**ISS set forth its full list of practices that it will consider on a case-by-case basis, whereas the 2011 Policy Updates set forth the most problematic pay practices that alone could cause ISS to recommend a withhold or against vote recommendation.

- **Consequence of having single-trigger vesting acceleration for equity awards—**ISS indicated that having single-trigger vesting acceleration for equity awards will not "automatically" result in an against vote recommendation on an equity plan proposal. However, ISS encourages double-trigger vesting of awards after a change in control (CIC). In the absence of double-trigger vesting, ISS prefers to see the Board given flexibility to determine the best outcome for shareholders. ISS does note that equity plans containing a liberal CIC definition coupled with single-trigger vesting acceleration upon a CIC are more likely to receive negative vote recommendations.

- **Consequence of providing a guaranteed opportunity (i.e., award size) for a performance-based award**—If the payout of an award ultimately depends on the performance attained, provided that no payout would occur if performance is below a specified hurdle level which appears reasonable, and the performance hurdles are reasonably robust, ISS believes the design would mitigate its typical concerns about a guaranteed award size.

- **Consequence of material amendments of existing agreements with problematic pay practices**—ISS will give the highest level of scrutiny and weight to such agreements that are extended or new. ISS will consider material amendments to be an opportunity for companies to fix problematic pay practices and will evaluate any such amended agreements as part of its holistic analysis.

- **Consequence of past company commitment regarding future problematic pay practices**—If a company has previously entered into a public commitment in response to an ISS vote recommendation

[2] For up-to-date tracking of SOP frequency vote recommendation information, *see* http://say-on-pay.com/say-on-pay-frequency-tracking/

to not include a certain problematic pay practice in new or amended agreements (such as an excise tax gross-up provision), and to which certain executives had their agreements grandfathered, unless the existing agreements are extended, they will not rise to the level of most problematic pay practices and draw a withhold or against ISS vote recommendation.

- **Consequence of a future commitment regarding problematic pay practices made during the last fiscal year before ISS announced 2011 policies—**ISS indicated that commitments not to enact problematic features in future agreements will no longer mitigate the enacting of problematic pay practices in new or amended agreements during the prior fiscal year.

- **How can a company with new or amended agreements containing problematic pay practices react to avoid ISS withhold or against vote recommendation?**—ISS indicated that a company could amend the agreements to remove the problematic pay practice provisions.

Exequity Comment: *ISS's FAQs on problematic pay practices likely will cause confusion. The FAQs do not establish any type of bright line for companies to consider when reviewing their pay practices (instead referencing "holistic evaluations"). Additionally, the FAQs offer little or no real opportunity to avoid a negative ISS vote recommendation if new or materially amended agreements with problematic pay practices exist (barring getting executives to agree to amend such agreement to completely remove such provisions – which will likely be a point of negotiation between companies and executives).*

Votes on Golden Parachutes

- **When would a say on pay vote be combined with a golden parachute vote?**—ISS indicated that the golden parachute vote would be considered part of the management SOP vote if the shareholder meeting proxy includes the prescribed golden parachute table, and in such case, that information would carry more weight in ISS's overall SOP recommendation. It won't matter whether it is a regular annual meeting or a meeting where shareholders are also voting on a CIC transaction.

- **Impact of a company deferring a golden parachute vote on its SOP vote—**ISS indicated that it has no policy on the timing of the golden parachute vote.

- **In its new policy regarding how it will vote on golden parachutes, ISS lists certain features that may lead to a vote against, including "[i]n the case of a substantial gross-up from [a] pre-existing/grandfathered contract: the element that triggered the gross up (i.e., option mega-grants at low point in stock price, unusual or outsized payments in cash or equity made or negotiated prior to the merger)." What does this quoted language mean?**—ISS indicated that an outsized, disclosed gross-up figure under a pre-existing/grandfathered contract would result in a closer look at the individual situation and what might have contributed to the substantial payment. ISS will conduct these evaluations on a case-by-case basis and may recommend against the golden parachute vote if it has significant concern. In other words, ISS is starting to chip away at its policy of grandfathering gross-up provisions in pre-existing agreements. A company may not be able to rely on the grandfathering policy if there is a "substantial" gross-up as in the examples listed. Note that the examples may not be an exclusive list and in our view, ISS has opened the door to reevaluate any gross-up it considers "substantial."

- **Consequence of payout of performance-based awards before performance for the performance period can be determined**—ISS indicated that best practice is to pay out performance-based awards on a pro-rata basis based on current achievement. If it is impossible to measure performance under the pre-determined performance criteria, the board should justify paying an award as if target or the highest performance goals were met.

- **Consequence of single-trigger payments—**ISS indicated that **any** type of single-trigger payment upon a CIC, be it cash or long-term incentive plan performance-based payouts (not just cash severance) could lead to a vote against the golden parachute vote. This means that a single-trigger payout of performance-based awards, as discussed in the previous question, could lead to a negative ISS outcome.
- **What single-trigger payments are considered?**—ISS indicated that for purposes of its vote recommendations with respect to votes on golden parachutes, it will consider all factors on a case-by-case basis, and so will not necessarily limit its consideration to new or amended agreements that contain single-trigger payments.
- **Are "potentially excessive severance payments" limited to cash severance?—**ISS indicated that for purposes of its golden parachute vote recommendations, it may consider all CIC-generated or accelerated payments, not just cash severance payments.

Exequity Comment: *ISS's FAQs on golden parachute votes make clear that if a company's shareholders are influenced by ISS, it should not include the say on golden parachute disclosures in its annual proxy if any of its golden parachute policies are not consistent with the ISS vote on golden parachute guidelines. Many companies still have single-trigger incentive payouts (payout on a CIC only) and excise tax gross-ups, and based on the ISS policy on golden parachutes, these design features could have an adverse impact on the SOP vote recommendation. Generally, we do not believe it is beneficial to include the golden parachute disclosures required for a vote on golden parachutes in the annual proxy and subject those disclosures to the SOP vote. Ironically, in this regard, the ISS guidelines will likely have the effect of influencing many companies to limit their parachute disclosures.*

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