

ISS 2011 Policy Updates: Alliance Advisors Summary

ISS recently released their 2011 policy updates, which are effective for shareholder meeting dates on or after February 1, 2011. On the surface, the changes for 2011 do not appear to be as substantive as they have been in years past. The following is a brief summary of the ISS 2011 policy updates.

Compensation

Say on Pay Frequency Vote

Not surprisingly, ISS will be recommending for the *annual* say on pay (SOP) vote. Alliance has recently spoken with several large non-ISS influenced institutional shareholders and the general consensus has been that an annual SOP vote is the “safe” or “default” frequency that issuers should utilize. What is unclear is what action(s), if any, ISS will take if shareholders approve a biennial or triennial SOP vote. One would have to assume ISS would have to abide by the “shareholders have spoken” philosophy.

Issuers that are predominantly held by institutional investors and intend to recommend the biennial or triennial SOP vote will need to explain clearly and concisely their rationale for a “non-annual SOP” vote in the proxy statement. Alliance is not of the opinion that volumes need to be dedicated to the rationale but rather a clear and concise focus on why a biennial/triennial SOP vote is the best method for a company’s compensation program. Companies must also be mindful of whether ISS or any large investors have taken issue with the company’s compensation practices in the past.

Please note that there was no ISS policy change with respect to the actual SOP vote.

Burn Rate

ISS is amending its policy to state that the allowable burn rate caps cannot change more than two percent (plus or minus) from the prior year’s cap. If a company exceeds the ISS burn rate cap, it still has the ability to make a public commitment to a three-year average burn rate of the industry mean plus one standard deviation (or two percent, whichever is greater). ISS will release the 2011 burn rate caps for each industry group in December 2011.

Because the ISS burn rate caps decreased significantly in 2010, ISS accepted commitments from issuers that used a blend of burn rate caps. For example, a company could commit to not exceed the average of the 2010 *and* 2009 burn rate caps. *Alliance has been told by ISS that the blended commitment will no longer apply.* Companies must commit to their current year industry burn rate cap.

Problematic Pay Practices

ISS has revised its list of problematic pay practices which, individually, could cause ISS to recommend against directors and/or SOP. The pay practices that fall within this category include:

- Repricing of underwater stock options/SARS without shareholder approval. This includes cash buyouts and voluntary surrender of underwater options.
- Excessive perks or tax gross-ups, including any gross-up related to a secular trust or restricted stock vesting. “Excessive” is not clearly defined by ISS, who seem to take a “we know it when it we see it” approach.
- New or extended agreements that provide for:
 - Change-in-control (CIC) payments exceeding three times base salary and average/target/most recent bonus.
 - CIC severance payments without involuntary job loss or substantial diminution of duties (single or modified single triggers).
 - CIC payment with excise tax gross-up or “modified” gross-ups.

For problematic pay practices, ISS will take action in the following manner:

- First, ISS will recommend against the SOP proposal.
- Second, ISS will recommend against/withhold on compensation committee members (or in rare cases the full board) in:
 - Egregious situations.
 - When no SOP proposal is on the ballot.
 - When the board has failed to respond to concerns raised in prior SOP votes.
- In addition, ISS may recommend against an equity compensation plan if it feels that excessive non-performance based equity awards are major contributors to a pay-for-performance disconnect.

In Alliance’s conversations with non-ISS influenced institutional shareholders, many took a similar approach to ISS in that if they take issue with a company’s compensation practices the first negative action will be to vote against the SOP proposal, and then the compensation committee in subsequent years if the issue(s) is not addressed. However, a few large institutions did say they could not divorce the two and that they would simultaneously vote against the SOP and the compensation committee for problematic compensation issues.

It will be interesting to see how this voting plays out in 2011, and if in fact compensation committee members receive fewer negative recommendations and votes. Issuers should still prepare as if committee members are still vulnerable to negative voting.

Please note that ISS maintains a list of “minor” problematic pay practices which, by themselves, would not be enough for ISS to take action. However, if a company maintains several of these “minor” practices it may be enough for ISS to take action as outlined above. Again, the test is very subjective so it is hard to determine when a company reaches the tipping point for ISS to take action.

Problematic Pay Practices – Commitments

For companies with ISS-defined problematic pay practices, *ISS will no longer accept future commitments as a way of preventing or reversing a negative vote recommendation.* For example, in the past a company could have avoided a negative recommendation for a gross-up on a perk by making a public commitment not to provide gross-ups on executive perks in the future (usually via an 8-K). This is no longer the case. ISS states that companies should fully understand their policies, thus prospective commitments on problematic pay practices will no longer be accepted. Please note that this change is effective immediately.

Prospective commitments will no longer be considered in the case of:

- Excise tax gross-up, single trigger (or modified single trigger) provisions in new or materially amended employment agreements,
- Excessive perks (again excessive is subjective),
- Tax gross-ups on perks,
- Guaranteed multi-year incentive awards, or
- Dividend payments on unvested performance shares.

Companies can still make future pay-for-performance commitments and/or burn rate assurances as well as on plan language (liberal change in control or repricing for example) related to certain equity plan grant practices.

While it is true that many companies and their various advisors are aware of ISS policy, there still remains a significant number of small- to mid-cap companies that are not as familiar with ISS guidelines. This stance by ISS leaves us asking, “Why punish a company that is unaware of ISS policy and ultimately wishes to do the right thing?” Couple that with the fact that ISS applies a subjective test to “excessive” perks and a company is left not fully understanding what will trigger ISS to issue a negative recommendation. We are hopeful that when ISS releases their compensation FAQ in the coming weeks they will bring some clarity to this new position.

Director Elections

ISS is amending its policy for uncontested director elections in two areas. First, ISS will recommend against/withhold on any director nominee(s) (except new nominees) who attend less than 75 percent of board and committee meetings unless an acceptable reason is given. ISS states acceptable reasons are generally limited to the following:

- Medical issues or illness,
- Family emergencies, and
- If the director’s total service was three meetings or fewer and the director missed only one meeting.

Although ISS has had an attendance policy for many years, the key change this year is that ISS will no longer accept a private disclosure explaining absences. All explanations must be clearly noted in the proxy or other SEC filings. Companies should take note that if the disclosure is not clear in the eyes of ISS (meaning they cannot determine if a director attended less than 75 percent of board and committee meetings) they will recommend an against/withhold on the director nominee(s) in question.

The second director-related change pertains to responsiveness to a majority-supported shareholder proposal. *ISS will recommend against/withhold on the entire board* (save new nominees depending upon how long they have been on the board), if the company failed to act on a shareholder proposal that received:

- A majority of the shares outstanding in the previous year, or
- The majority of the shares cast in the last year and one of the previous two years.

It is uncertain how ISS will treat similar but not identically worded shareholder proposals. For example, in 2011 a shareholder proposal asking for shareholder ability to call a special meeting with a 10 percent trigger received the favorable vote of a majority of the votes cast. In 2010 (or 2009) a similar proposal but requesting a 25 percent trigger received a majority of the votes cast. In 2012 would the directors be in danger of a negative recommendation from ISS if they took no action because the proposals are not asking for exactly the same thing?

General Governance

Country of Incorporation

Companies domiciled outside the US but subject to SEC filing requirements (DEF 14As, 10-K, 10-Q filers) will be analyzed by ISS using the US guidelines. Previously, these companies were subject to the ISS guidelines of their place of domicile. In Alliance's experience, this should be a positive change for most of these companies, particularly as it pertains to compensation plans. Companies will be analyzed using ISS' proprietary model (and other US recommendation drivers such as burn rate), instead of a straight line voting power dilution test which tended to be quite rigorous and not in line with the granting practices of most US-domiciled companies.

Shareholder Ability to Act by Written Consent

ISS has typically recommended FOR shareholder proposals seeking the right for shareholders to act by written consent, considering the following factors:

- Shareholders' current right to act by written consent,
- The consent threshold,
- The inclusion of exclusionary or prohibitive language,
- Investor ownership structure, and
- Shareholder support of (and management's response to) previous shareholder proposals.

In 2010, ISS recommended in favor of all shareholder proposals asking for shareholder ability to act by written consent. According to their 2010 US Post Season Report, the proposals average about 54 percent support from shareholders.

ISS is amending its policy to state that it will now review shareholder proposals seeking the ability to act by written consent on a *case-by-case* basis. In addition to the above, ISS will also consider whether the company has the following:

- A right for shareholders to call a special meeting at a 10 percent threshold.
- A majority vote standard in uncontested election of directors.
- A non-shareholder approved rights plan (poison pill).
- An annually elected board.

Common Stock Authorizations

With respect to Board proposals seeking to increase the company's authorized common stock, ISS will want companies to enhance their disclosure around the risks of not securing shareholder approval of the proposal. In addition, ISS will recommend against capital increases when there is also a reverse stock split on the ballot and the authorized shares would not be proportionally reduced.

Please direct questions regarding any of the above to Reid Pearson, Executive Vice President (rpearson@allianceadvisorsllc.com).