CAPflash
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ISS 2011 Policy Updates: Here Comes Say on Pay

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On November 19th, proxy advisory firm Institutional Shareholder Services (ISS) issued voting policy updates that apply to shareholder meetings held on or after February 1, 2011. Notable policy updates related to compensation include the following:

- Modified burn rate policy
- Recommendation for annual Say on Pay vote frequency
- Modified definition of "egregious" pay practices
- No longer accepting future commitments to revise practices as a means to prevent or reverse a negative vote recommendation
- A policy for vote recommendations on Say on Golden Parachutes

Changes in Equity Compensation Plan Burn Rate Policy

As a means of limiting the impact of market volatility on its equity burn rate analysis, ISS decided to limit "year-to-year changes possible in allowable [burn rate] caps" (important as ISS uses its burn rate cap to assess a company's use of equity relative to industry peers) to no more than two percentage points.

Later this month, ISS plans to publish the related (updated) industry-specific burn rate table that will be used to determine its equity plan approval (or additional share request) vote recommendations.

Say on Pay Vote Frequency

Under the recent Dodd-Frank legislation, companies are required to provide shareholders with a non-binding choice on the frequency of a non-binding Say on Pay vote, with the options being every 1, 2, or 3 years. ISS is strongly advocating annual Say on Pay votes; ISS believes that annual Say on Pay votes provide for the "most consistent and clear communication channel for shareholder concerns about companies' executive pay programs."

Therefore, if a company plans to recommend / support a non-annual vote frequency, we recommend that the company's management (possibly with the assistance of their outside advisors) reach out to major shareholders as their proxy filing is prepared. This is important to do ahead of time as ISS has a policy to recommend Withhold or Against votes for the entire Board of Directors if the Board fails to act on a shareholder proposal that received approval by a majority of the shares outstanding. That said, it is remains to be seen how this policy will apply to companies that do not comply with the voting preferences of the plurality of shareholders for Say on Pay frequency. This is an issue that will likely receive attention from ISS in the future.

Individual Problematic Pay Practices / Negative Say on Pay Recommendations

ISS highlighted specific problematic pay practices that it views as particularly egregious and may independently, "by themselves, [be] sufficiently problematic to warrant Withhold or Against votes in most circumstances." These "egregious" pay practices include:

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- Repricing or replacing underwater stock options / SARs without 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
- New or extended agreements that provide for:
  - CIC (Change in Control) payments exceeding 3x 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 payments with excise tax gross-ups (including "modified" gross-up)

Companies with these "egregious" practices can generally expect:

- Against vote recommendations for Say on Pay
- Against / Withhold recommendations on Compensation Committee members:
  - In egregious situations (ISS does not define what this is)
  - When no Say on Pay vote is on the ballot (potentially an argument for annual Say on Pay votes)
  - When Board has failed to respond to concerns from prior Say on Pay votes
- Against equity incentive plan proposal if excessive non-performance-based equity awards are major contributors for pay-for-performance misalignment.

ISS also states that agreements with evergreen provisions will receive "particular scrutiny," possibly because they provide an avenue for grandfathering "egregious" pay practices indefinitely. What is somewhat unclear is that despite the above mentioned policy update, ISS continues to state that it will continue to evaluate programs on a case-by-case basis in the context of a company's overall pay program and historic pay actions, including other problematic pay practices cited in the past.

In all likelihood, a result of this policy update will be more companies receiving negative vote recommendations from ISS. Therefore, if companies plan to maintain or add any of these compensation program features, it is especially important that they proactively initiate dialogue with their largest shareholders to provide the rationale for why these pay practices are in shareholders' interests.

Future Commitments / Negative Recommendations

ISS says that it will no longer accept "future commitments on problematic pay practices as a way of preventing or reversing a negative vote recommendation," with the associated rationale that its policies are widely available and have been well known for some time. ISS also goes a step further in critiquing the corporate governance process, by stating that companies need to spend more time considering a "cure" for such practices.

There are, however, some exceptions to this policy. ISS states that exceptions now include:

- Pay-for-performance and burn rate commitments
- Plan language related to certain equity grant practices (e.g., liberal CIC definition)

Criteria for Recommendations on Say on Golden Parachutes

ISS' policy is to take a case-by-case approach regarding recommendations for the vote on golden parachute

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compensation. The vote recommendation will be consistent with ISS' pre-existing policies on problematic pay practices related to severance packages. Specific features identified as potentially leading to an Against vote include:

- Recently adopted or materially amended agreements that include excise tax gross-up provisions (since prior annual meeting)
- Recently adopted or materially amended agreements that include modified single triggers (since 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
- In the case of a substantial gross-up from 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)
- The company's assertion that a proposed transaction is conditioned on shareholder approval of the golden parachute advisory vote. ISS would view this as problematic from a corporate governance perspective

ISS indicated that in cases where the golden parachute vote is incorporated into the overall Say on Pay vote for the company, ISS may place a heavier weight on golden parachute compensation in determining its vote recommendations for Say on Pay. In our view, the new guideline is largely consistent with ISS' existing policies on severance compensation and should not present problems for companies that have moved to address their change-in-control severance practices.

Conclusions

Due to ISS' level of influence, it is important for companies / Committee members to be aware of its policies. If ISS voting recommendations strongly influence a company's shareholder base, those companies should regularly review their programs against ISS policies and educate their directors on the impact of the policies, so as to not be surprised by an ISS voting recommendation.

Further, Say on Pay will receive a lot of attention during the upcoming proxy season, and ISS has expressed a clear preference for annual votes. If companies do not provide for an annual Say on Pay vote, ISS will likely use Against or Withhold vote recommendations on director elections as its means to express dissatisfaction with compensation programs.

Please contact us at (212) 921-9350 if you have any questions about the issues discussed above or would like to discuss your own executive compensation issues. You can access our website at www.capartners.com for more information on executive compensation.