RADFORD ALERT

2011 ISS Policy Updates

On November 19, 2010, Institutional Shareholder Services, Inc. (ISS) released its *US Corporate Governance Policy—2011 Updates*. The new policy updates are effective for public companies holding annual shareholders' meetings scheduled to occur on or after February 1, 2011. The updates related to ISS's policies on Management Say on Pay (MSOP) proposal frequency, Problematic Pay Practices policy, and equity-based compensation plans are summarized below.

MSOP Frequency

Based upon feedback from institutional subscribers, ISS is adopting a new policy to recommend a vote FOR annual advisory votes on compensation. ISS supports an annual MSOP vote for the same reasons it supports the annual election of all directors (i.e., it provides the highest level of accountability and direct communication between shareholders and issuers). According to ISS, having MSOP votes every two to three years, covering all actions occurring between the votes would make it more difficult for companies to know whether the shareholder vote results are a reflection of current or past compensation practices.

Radford Perspective: *ISS's recommendation for an annual frequency (MSOP) approach was expected. It is highly unlikely that even the most robust explanation supporting a frequency other than annual would receive support from ISS. Since ISS has indicated that it will use the MSOP vote as its first/primary recourse (rather than voting against the re-election of directors) when it discovers Problematic Pay Practices at a company, holding an annual vote has the potential to benefit companies by minimizing votes against directors.*

Problematic Pay Practices

In anticipation of the legislative requirement that public companies implement MSOP proposals, ISS previously established its framework for the application of its Problematic Pay Practices policy to MSOP proposals. Consistent with the same approach utilized in its 2010 policies, ISS has disclosed the following framework for making vote recommendations on MSOP proposals:

If a company maintains problematic pay practices, ISS will generally vote:

- AGAINST management MSOP proposals;
- AGAINST/WITHHOLD on compensation committee members (or in rare cases where the full board is deemed responsible, all directors including the CEO):
  - When no MSOP item is on the ballot;
  - In Egregious situations; or
  - When the board has failed to respond to concerns raised in prior MSOP evaluations

ISS will also continue to vote AGAINST equity incentive plan proposals if excessive non-performance-based equity awards are the major contributors to a pay-for-performance misalignment.

Radford Perspective: *As noted, this process is not new, as ISS already used this compensation evaluation framework during the 2010 proxy season.*

Prospective Commitments to Eliminate Problematic Pay Practices

In past years, ISS allowed companies to avoid negative vote recommendations on proxy ballot items by making a public commitment to eliminate a specific problematic pay practice prospectively. However, the 2011 policies state that ISS will no longer accept future commitments on problematic pay practices as a way of preventing or reversing a negative vote recommendation (with the exception of certain equity plan proposal related items, such as burn rate commitments, plan document language commitments, and pay-for-performance commitments).

Specifically, prospective commitments to eliminate the following problematic pay practices will no longer be considered by ISS:

- Excise tax gross-ups, single-trigger, and modified single-trigger provisions in future new or materially amended employment agreements;
- Excessive perquisites, including home loss buyouts;
- Tax gross-ups on perquisites;
- Guaranteed multiyear incentive awards; and
- Dividend payments on unvested performance shares.

Radford Perspective: *Given that ISS will no longer accept prospective commitments to eliminate what ISS deems to be "problematic" practices, it will be important for companies to increase disclosure in the CD&A and MSOP proposal to effectively mitigate any negative scrutiny from ISS (i.e., whether the company plans on eliminating such practices and/or the rationale for the implementation or ongoing use of any problematic practices).*

Case-by-Case Evaluation of Most Problematic Pay Practices

In its 2011 policies, ISS revised its list of most Problematic Pay Practices, the presence of which may ultimately result in a negative vote recommendation on a stand-alone basis. Under the 2011 policies, the following pay practices will be considered most problematic:

- Repricing or replacing underwater stock options or stock appreciation rights without shareholder approval;
- Excessive perquisites or tax gross-ups; and
- Entering into new or extended agreements that provide for:
  - Change in control (CIC) payments of more than three times base plus average/target/most recent bonus;
  - CIC severance payments without involuntary job loss or substantial diminution of duties ("single" or "modified single" triggers); and/or
  - CIC payments with excise tax gross-ups (including "modified" gross-ups).

Radford Perspective: *Even though ISS has decreased the number of "most" problematic pay practices that on a stand-alone basis can automatically result in negative vote recommendations, it is our opinion that it is likely that the identification of one or more of the previously listed Problematic Pay Practices in ISS's 2010 policies will result in a negative vote recommendation under ISS's new case-by-case compensation evaluation framework during the 2011 proxy season. Companies should evaluate existing plans and programs for any ISS exposure items under ISS's Problematic Pay Practices policy.*

Say on Golden Parachutes

The 2011 policies also summarize certain "problematic" features that may lead to negative vote recommendations on the new advisory votes on golden parachutes in M&A transactions:

- Recently adopted or newly amended agreements that include excise tax gross-up provisions (since prior annual shareholders' meeting);
- Recently adopted or materially amended agreements that include modified single triggers (since prior annual shareholders' meeting);
- Single-trigger payments that will happen immediately upon a CIC, including a 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 a CIC 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); or
- The company's assertion that a proposed transaction is conditioned on shareholder approval of the golden parachute advisory vote.

Note: *In cases where the disclosures for the golden parachute vote are voluntarily incorporated in the annual proxy disclosures covered by the company's separate MSOP proposal, ISS will evaluate the MSOP proposal in accordance with its Say on Golden Parachute guidelines, which may give greater weight to that component in the overall MSOP evaluation.*

Radford Perspective: *When voluntarily incorporating the disclosures for the golden parachute vote into the company's annual proxy, careful consideration is required to assess the likelihood of whether design features could negatively impact ISS's overall evaluation of the company's MSOP proposal. Additionally, single-trigger acceleration of performance-based awards (not based on actual performance) as a problematic practice is new under the 2011 Policies. This policy is likely to result in increased negative scrutiny from ISS for many public companies.*

Burn Rate Policy

Consistent with previous years, 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 (segmented by Russell 3000 index and non-Russell 3000 index); or
- Two percent of the total basic weighted average common shares outstanding.
- ISS will publish the new industry burn rate caps for 2011 in January.

More Information

We encourage you to forward this Alert to your board members. And as always, we encourage you to contact us if you have questions. For more information, contact:

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About Radford

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