

# PROXY UPDATE

January, 2011

## 2011 ISS Proxy Guidelines Update

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Recently, Institutional Shareholder Services Inc. (“ISS”) posted a list of FAQs regarding their updated policies and voting guidelines for 2011. In light of this new information, we believe it is beneficial to further review and analyze the 2011 guidelines (which will generally be effective for any shareholder meeting taking place after February 1, 2011).

While the revisions to specific ISS policies are not as far reaching as some of ISS’ previous policy revisions, there are still a number of changes that will be important for issuers to be aware of in preparation for the coming year. The most significant change, in our view, is the use of a “holistic” approach by ISS, which will allow them leeway to consider issues that may be tangential to the proposal at hand. We believe this will provide them with greater flexibility to consider other factors when making recommendations on board-related, compensation-related and corporate governance proposals. Some of the other key changes are summarized below, with more detail later in this Update.

The combination of ISS policy changes as well as regulatory changes (mandated Say on Pay and Frequency on Pay) argues for a comprehensive analysis of the substance and format of what shareholders will be asked to vote on at your annual meeting. Understanding your vulnerabilities and potential pitfalls prior to mailing your proxy statement allows issuers the time to craft their talking points and to take their case directly to investors if necessary. Please see our earlier [newsletter](#) for some recommendations for constructive engagement with your institutional shareholders.

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### Key Changes

- ISS is increasing its focus on what it considers “problematic pay practices”.
- ISS will no longer allow issuers to make a prospective commitment to eliminate a poor pay practice as a way of avoiding or reversing a negative recommendation on a director or on a management Say on Pay proposal.
- While all employment agreements are weighed as part of ISS’ holistic approach, agreements that perpetuate problematic pay practices, such as new or extended agreements are considered the most problematic and will receive the highest scrutiny. ISS will pay particular attention to amended auto-renewing (“evergreen”) agreements.
- While ISS has revised and shortened the list of egregious problematic pay practices that by themselves may result in a negative recommendation, it is very important to note that the list is not all inclusive.
- As expected, ISS will recommend in favor of an annual frequency for management Say on Pay votes.
- ISS will no longer accept private disclosure of the reasons for a director’s absence (this is in the context of a director that has attended less than 75% of board meetings). ISS now requires public disclosure of the reasons for the absences in the proxy statement or some other public filing with the SEC.
- ISS has amended its policy related to withholding on directors in response to shareholder proposals that have received a majority of shares voted in favor. ISS will now include proposals that received a majority of shares voted in favor in the last year and one of the two previous years.
- For proposals seeking an increase in common stock, ISS is changing the calculation methodology that determines what ISS considers to be an allowable increase, and will not be using their proprietary model any longer. ISS also indicates that it has a “strong preference” for requests of 100% or less of the existing authorized.

Below is more detail on some of these key changes.

## Compensation

Under their holistic review of executive compensation, the analysts at ISS will have some latitude in their determination of whether the good aspects of your compensation practices outweigh the bad aspects. If the mix of good to bad is not sufficient, it could result in a negative recommendation on directors, Say on Pay and compensation-related proposals.

### **Prospective Commitments to Change Problematic Pay Practices are No Longer Allowed**

In perhaps the most impactful change to their compensation policies, ISS will no longer accept a prospective commitment (typically disclosed in an 8-K) that addresses a problematic pay practices in an effort to prevent or reverse a negative vote recommendation. *This policy update was effective November 19, 2010.*

However, if an issuer actually removes the problematic pay practice, ISS will consider changing its recommendation.

### **Lists of Problematic Pay Practices are Not All-Inclusive**

Under the 2011 policies, ISS has created a new list of problematic pay practices for which an issuer can't make a commitment to change if the issuer has received a negative recommendation due to one or more of these problematic pay practices (what we will call the "No Prospective Commitment List" or "NPC List"). In addition, ISS has reduced the list of egregious problematic pay practices that carry "significant weight" and that, by themselves, can result in a negative recommendation.

The fact that the NPC List enumerates specific problematic pay practices would seem to infer that there are problematic pay practices that are not on the list for which an issuer could make a prospective commitment. *That is not the case; the NPC list is not all-inclusive.* Based on our discussions with ISS, they will no longer accept prospective commitments for any problematic pay practices (not just those on the NPC List), with the exception of burn rate commitments and pay for performance commitments.<sup>1</sup>

In addition, the shortened list of egregious problematic pay practices list is not all-inclusive; it is only a list of the problematic pay practices that carry the most weight. Issuers must be cognizant of the full list of problematic pay practices, not just those on the shortened list. If a company has enough problematic pay practices, whether on the list or not, it can result in an Against recommendation.

### **Greater Scrutiny for New or Extended Agreements, Highest for Evergreen**

Another important change in the ISS policy relates to employment agreements. In its new policy, ISS is especially focused on new or extended agreements that "help to perpetuate problematic pay practices". In its Compensation FAQs, ISS states that "new agreements and extended agreements are the most problematic and will receive the highest scrutiny". Further, ISS says they will pay particular attention to amended employment agreements that have automatic roll over features ("evergreen").

If a particular agreement has what ISS deems a problematic pay practice that could weigh heavily under the ISS holistic review of compensation and could be a contributing factor in a recommended vote against a management Say on Pay proposal and/or withhold on the compensation committee members. Every issuer should be aware if any of their NEO's employment agreements have an automatic renewal feature and contain problematic pay practices, and if so, they should consider whether steps should be taken now to cure the situation or at the very least inform the Board of the potential consequences.

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<sup>1</sup> For non-compensation issues, ISS will still allow for prospective commitments on board independence, poison pills, reducing overboarding, stepping off committees, etc.

### **Say on Severance**

Based on the new rules required under Dodd-Frank, ISS has instituted a new policy to review golden parachutes in a business combination on a case-by-case basis. Consistent with ISS' compensation policies, ISS may recommend a vote against golden parachutes that contain problematic pay practices such as excise tax gross-ups, single trigger payments, excessive severance payments, etc. Essentially, ISS will review golden parachutes for features that they believe "provide inappropriate windfalls and cover certain tax liabilities for executives".

Dodd-Frank only requires a Say on Severance vote when shareholders are voting on a change in control transaction and ISS has not yet instituted a policy on the timing of the Say on Severance vote. ISS has indicated that it will not fault companies for not including a Say on Severance vote at an annual meeting as part of Say on Pay proposals during 2011.

### **Equity Compensation Plans: Burn Rate**

ISS has made changes to its Burn Rate Cap policy for equity plans to minimize the year-to-year changes possible in the allowable caps. The rationale for the change is that from 2009 to 2010, the ISS Burn Rate Caps of many industry groups dropped significantly. To avoid dramatic swings in the future, ISS has imposed restrictions on the fluctuations of these caps. Specifically, the ISS Burn Rate Caps will not shift (plus or minus) 2% year-over-year.

We do not view this action as meaningful, since it will primarily impact companies that are not part of the Russell 3000 Index.

## **Board of Directors**

### **Attendance at Board & Committee Meetings**

ISS will recommend a vote against or withhold on directors that have attended less than 75% of board and committee meetings unless they have an acceptable reason. In the past, ISS would accept private disclosure of the reasons for a director's absence. ISS is removing private disclosure as an option and will require public disclosure of the reasons for the absences in the proxy statement or some other public filing with the SEC. Acceptable reasons will generally be limited to medical issues and family emergencies. As is required by the SEC, ISS will look for disclosure of the number of board and committee meetings that were held during the year. Inadequate disclosure in this regard could lead to a negative recommendation.

### **Responsiveness to Majority Vote Shareholder Proposals**

ISS has changed its policy relating to withholding on the board if the board ignores a majority supported shareholder proposal. Currently, ISS will withhold on board members at the next annual meeting if a shareholder proposal had received a favorable vote of a majority of the outstanding shares in the previous year or a majority of the shares voting in the previous two years. ISS has amended its policy related to proposals receiving a majority of shares voted to include proposals that received a majority of shares voted in the last year and one of the two previous years.

### **Cumulative Voting**

Current ISS policy calls for voting in favor of shareholder proposals seeking to implement cumulative voting in director elections unless the company "has adopted a majority vote standard, with a carve-out for plurality voting in situations where there are more nominees than seats, and a director resignation policy to address failed elections" and allows for "...proxy access or a similar structure...". ISS removed the "similar structure" language because they believe it was unnecessary due to the lack of companies that have adopted alternative approaches, the presence of proxy access provisions in certain states (like North Dakota) and the probability that the federal proxy access rules will become a reality in the near future.

## Shareholder Rights and Defenses

### Shareholder Proposals to Act by Written Consent

With many companies having already moved to allow shareholders to call special meetings, attention is turning to the ability of shareholders to act by written consent. While the number of proposals seeking to implement action by consent have been relatively modest in the past, we expect there will be an increase in these proposals moving forward. Written consent is most often used in hostile situations, and allows a dissident to act more quickly than they would be able to using the right to call a special meeting, which is a two-step process.

Under the revised policy on this proposal, ISS will continue to generally recommend For a shareholder or management proposal allowing for written consents. However, ISS will consider shareholder proposals on this topic on a case-by-case, taking a more “holistic” view of the company’s overall corporate governance.

In particular, ISS will look to see if shareholders have an “unfettered”<sup>2</sup> right to call special meetings at a 10 percent threshold, a majority vote standard in uncontested director elections, no non-shareholder approved pill; and an annually elected board.

By considering a company’s governance structure in their recommendation determination, ISS may determine that such a right is unnecessary and will recommend against the proposal.

### NOL’s

ISS is changing their policy on Net Operating Loss (NOL) protective amendments and poison pills. While ISS understands the general need for these proposals to protect a potentially valuable asset in the NOLs, they have added that both the protective amendment and the NOL poison pill should have a 3-year sunset provision. They believe that the duration of the NOL amendments and the pills are of primary consideration for investors, especially given the low ownership thresholds (5%) involved. They believe a 3-year sunset is reasonable. It is important to note that, even though ISS and most investors recognize the need for NOL pills, shareholder approval of them is paramount. ISS will recommend a withhold or against vote on directors who adopt an NOL pill without shareholder approval, even if the pill is favorable to shareholders.

## Capital Structure

### Common Stock Authorization

ISS has made a number of changes to its policy regarding proposals seeking an increase in common stock. One of the key changes to the policy is to encourage clear disclosure of both the specific purposes of the capital requested and, more importantly, the “specific and severe” risks to shareholders of not approving the request. Another key change to the policy is that ISS will no longer employ a proprietary model to determine an issuer’s allowable increase; rather they will apply broad guidelines outlined below (ISS released these guidelines recently in a FAQ). Under their new policy; they will have a “strong preference” for requests of 100% or less of the currently authorized capital stock. ISS is also now specifying that they will recommend for proposals to increase common where the primary purpose for the increase is in connection with a transaction on the same ballot.

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<sup>2</sup> ISS considers an unfettered” right to mean “no restrictions on agenda items, no restrictions on the number of shareholders who can group together to reach the 10 percent threshold, and only reasonable limits on when a meeting can be called: no greater than 30 days after the last annual meeting and no greater than 90 prior to the next annual meeting.”

Below are the guidelines ISS will use to determine the allowable increase in authorized common stock for general corporate purposes (or to the general corporate purposes portion of a request that also includes a specific need):

- Most companies: **100 percent** of existing authorized shares
- Companies with less than 50 percent of existing authorized shares either outstanding or reserved for issuance: **50 percent** of existing authorized shares
- Companies with one- and three-year total shareholder returns TSRs in the bottom 10 percent of the U.S. market as of the most recently completed calendar quarter: **50 percent** of existing authorized shares
- Companies at which conditions B. and C. above are both present: **25 percent** of existing authorized shares
- Companies that also include on the ballot a reverse stock split proposal that is not accompanied by a proportional reduction in authorized shares: **Zero**

If there is an acquisition, private placement, or similar transaction on the ballot (not to include equity incentive plans), the allowable increase will be the greater of (i) twice the amount needed to support the transactions on the ballot, and (ii) the allowable increase as calculated in A. through E. above.

### Reverse Stock Splits

ISS has also added one other reason to vote against an increase in authorized common or preferred stock. ISS has indicated that they have seen an increase in the number of dual requests on the same ballot: reverse stock split that does not also proportionately decrease the authorized shares, as well as an increase in common stock. ISS believes that what is effectively two increases in common stock on the same ballot should receive an against recommendation.

### Social/Environmental Issues

ISS change in this area was limited to updating the policy regarding Environmental, Social and Governance (ESG) compensation-related proposals. The policy itself remains the same but certain language was removed that was deemed outdated and unnecessary. ISS has removed language from its policy that indicated that the practice of linking executive compensation to ESG criteria was the exception. ISS states that it believes the issue appears to be moving into the mainstream and the policy should reflect the “evolving discourse”.

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Morrow & Co. is available at any point to answer your questions or assist you as you move toward the 2011 proxy season. Please feel free to contact your Morrow representative with any questions you may have. You may also contact Tom Ball, John Ferguson, or Fred Marquardt at 203-658-9400.

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