

Meridian Client Update

December 9, 2010

ISS Releases its 2011 U.S. Corporate Governance Policy Updates

On November 19, 2010, Institutional Shareholder Services (ISS) (formerly known as RiskMetrics Group) released its 2011 Updates to its U.S. Corporate Governance Policies. As the end product of ISS' policy formulation process, the 2011 Updates make material changes and modifications to its existing policies, as well as address new topics such as the frequency vote on say on pay proposals. Below we summarize the 2011 Updates that relate to executive compensation. These policies will be effective for meetings occurring on or after February 1, 2011, except for the new policy on commitments to remedy problematic pay practices, which is effective immediately.

Equity Compensation Plans: Burn Rate

ISS considers the reasonableness of a company's three-year average burn rate (or "run rate") in evaluating most equity plan proposals. The three-year average burn rate policy looks at a company's equity awards over the past three fiscal years and compares it to a pre-established industry and index benchmarks.

Currently, ISS will recommend to vote AGAINST new or amended equity plans for a company whose average three-year burn rate exceeds the greater of: (1) the mean plus one standard deviation of the company's GICS group and (2) two percent of the weighted common shares outstanding. Under its new policy, year-to-year changes in burn rate cap changes will be limited to a maximum of two percentage points (plus or minus) the prior year's burn rate cap.

***Meridian Commentary.** ISS explains that this policy change is intended to compensate for (i) outlier companies within any specific GICS group and (ii) the impact of recent market volatility that may result in extraordinary changes in annual burn rate caps not actually reflective of average usage. ISS will include an updated burn rate table in its 2011 Summary Guidelines, to be released in December 2010. Upon the release of the updated burn rate table, companies should consider monitoring whether their equity grant practices fall within ISS' prescribed burn rate caps.*

Frequency of Advisory Votes on Executive Compensation

ISS is adopting a new policy in response to the new U.S. proxy requirement under Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), which amended the Securities Exchange Act of 1934 by adding new Section 14A. The amended statute mandates that public companies with shareholder meetings occurring on or after January 21, 2011 provide a non-binding advisory resolution regarding whether future advisory votes on executive compensation ("say on pay") should occur every year, two years or three years. Under its new policy, ISS will recommend that shareholders vote for **annual** advisory votes on executive compensation. ISS believes that an annual say on pay vote will provide the most consistent clear communication channel for shareholder concerns about companies' executive pay programs.

Meridian Commentary. ISS' policy in support of an annual vote on compensation is not surprising given its existing policies aimed at fostering accountability, such as its support of annual election of directors. As we have previously noted, board of directors may include in proxy materials a recommendation on say on vote frequency, provided that the proxy clearly indicates that shareholders are not voting to approve or disapprove the board's recommendation (See Meridian's Client Update Vol. 1, Issue 16, dated October 29, 2010). ISS' policy in favor of an annual advisory vote on executive compensation may create momentum toward annual say on pay vote becoming the normative or best practice in the U.S.

ISS has not developed any policy guidelines regarding the implications of a company's decision not to adopt the say on pay vote frequency supported by a plurality of the votes cast. Presumably, any prospective ISS policy would view favorably a board that decides to adopt a more frequent vote policy than the one supported by a plurality of the votes cast.

Problematic Pay Practices

ISS' previous policy guidelines and its updated policy guidelines both provide that when a company maintains "problematic pay practices," ISS will generally recommend a vote:

- AGAINST management "say on pay" (MSOP) proposals;
- AGAINST/WITHHOLD on compensation committee members (or in rare cases where the full board is deemed responsible, all directors including the CEO):
 - In egregious situations;
 - When no MSOP item is on the ballot; or
 - When the board has failed to respond to concerns raised in prior MSOP evaluations; and/or
- AGAINST an equity incentive plan proposal if excessive non-performance-based equity awards are the major contributors to a pay-for-performance misalignment.

Under its prior policy guidelines, ISS identified numerous problematic pay practices, the existence of which could influence its vote recommendations. The updated policy guidelines identify a select number of these pay practices that are considered "most egregious" under the problematic pay practices section of ISS' executive compensation policy. These egregious pay practices "carry significant weight" in ISS' assessment of a company's pay programs and may result in an adverse vote recommendation. ISS policy update further suggests that the presence of an egregious pay practice, standing alone, is sufficiently problematic to warrant withhold or against votes **in most circumstances**. However, ISS notes that its vote recommendation will continue to be made on a **case-by-case basis** and that egregious pay practices along with other problematic pay practices may ultimately result in negative vote recommendations based on consideration of a company's overall pay programs and past practices.

The egregious pay practices outlined in ISS policy update are discussed below.

ISS Egregious Pay Practices	Meridian Observations
<ul style="list-style-type: none"> ■ Repricing or replacing of underwater stock options/SARS without prior shareholder approval (including cash buyouts and voluntary surrender of underwater options) 	<p><i>Informally, ISS has advised us that the practice of repricing underwater stock options/SARS without prior shareholder approval constitutes a problematic pay practice, whereas merely including such a provision in an existing plan would not constitute a problematic pay practice under ISS' updated policy. However, an equity plan that permits repricing without a shareholder vote would cause ISS to issue a vote recommendation AGAINST the plan if shareholder approval of the plan is being sought.</i></p>
<ul style="list-style-type: none"> ■ Excessive perquisites or tax gross-ups, including any gross-up related to a secular trust or restricted stock vesting 	<p><i>Under prior ISS policy, excessive perquisites were limited to perquisites provided to former and retired executives and extraordinary relocation benefits (including home buyouts) for current executives. The policy update does not define the term excessive perquisite; therefore, it is unclear whether ISS is continuing its prior policy. The policy update on tax gross-ups appears to be substantially similar to ISS' prior policy.</i></p>
<ul style="list-style-type: none"> ■ New or extended agreement that provides for (see items below): 	<p><i>Under prior ISS policy guidelines, materially amending an agreement containing a pre-existing problematic CIC feature could result in an ISS adverse vote recommendation. The new policy update appears to narrow the prior policy guidelines solely to amendments that extend the term of an agreement containing a pre-existing problematic pay practice.</i></p> <p><i>Other material amendments to an agreement containing a pre-existing problematic pay practice would not, standing alone, result in an ISS adverse vote recommendation but would be considered as part of ISS "holistic review" of a company's overall compensation program.</i></p> <p><i>The policy update is not clear with respect to the treatment of agreements extended by virtue of an evergreen provision. The update however does indicate that where an amended agreement contains both a problematic pay practice and an evergreen provision, the agreement may receive "particular scrutiny" by ISS. The significance of this "particular scrutiny" is not specified in the update.</i></p>
<ul style="list-style-type: none"> — Change in control ("CIC") payments exceeding 3 times base salary and average, target or the most recent bonus 	<p><i>Under prior ISS policy guidelines, CIC payments exceeding 3 times base salary and target bonus were considered excessive and a problematic pay practice. The updated policy expands the definition of bonus to also include "average" bonus and the "most recent bonus." By implication, the importance of this policy update is that it sets forth a permissible range of bonus definitions that may be used in CIC cash severance formulas. Specifically, a CIC cash severance formula that defines bonus as target, average or most recently paid bonus would not be considered an egregious pay practice provided, that the cash severance payments under the formula do not exceed 3x base and bonus.</i></p>
<ul style="list-style-type: none"> — CIC severance payments without involuntary job loss or substantial diminution of duties ("single" or "modified single" triggers); or 	<p><i>This egregious pay practice is the same as under prior ISS policy guidelines.</i></p>
<ul style="list-style-type: none"> — CIC payments with excise tax gross-ups (including "modified" gross-ups) 	<p><i>This egregious pay practice is the same as under prior ISS policy guidelines.</i></p>

Future Commitment to Cure Problematic Pay Practices

Effective immediately, ISS will no longer accept a company's prospective commitment to cure a problematic pay practice as a way of preventing or reversing an ISS negative vote recommendation. Nevertheless, ISS encourages companies to adopt forward-looking policies to address problematic pay practices. ISS will continue to evaluate compensation practices on a holistic basis relative to a company's overall program and the compensation committee's track record of responsible stewardship.

Under its new policy, prospective commitments to eliminate or curtail the following problematic pay practices will no longer be considered in ISS' determination of a vote recommendation:

- Excise tax gross-up, single trigger and modified single trigger provisions in new or materially amended employment agreements;
- Excessive perquisites, including home loss buyouts and other perquisites provided to NEOs which are deemed excessive;
- Tax gross-ups on perquisites, such as for life insurance, personal use of corporate aircraft, home security and certain relocation benefits, as well as gross-ups for grantor trusts and restricted stock vesting;
- Guaranteed multi-year incentive awards; and
- Dividend payments on unvested performance shares.

Previously, when ISS had identified a problematic pay practice, it generally accepted a commitment by a company that it would eliminate such practice going forward, thus precluding a negative vote recommendation from ISS. In its Policy Updates, ISS explains the former policy on prospective commitments to eliminate a problematic practice was intended to provide a transitional mechanism, to give issuers time to understand evolving policy guidelines, rather than a permanent "cure" system that "provides limited benefit to shareholders and calls into question the board's process for adopting improved compensation practices."

ISS has provided two exceptions to its new policy:

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

Meridian Commentary. *The elimination of the "cure" route to secure a favorable ISS vote recommendation should not prove problematic for most large companies. For the most part, the problematic pay practices no longer subject to "cure" are fairly uncommon practices among large public companies, except for excise tax gross-ups on change-in-control severance payments. However, it appears that this policy update does not impact ISS' grandfather rule that exempts from its problematic pay practice policy excise tax gross-ups included in employment or CIC severance agreements entered into prior to February 1, 2009 and not materially amended since then.*

Vote on Golden Parachutes

ISS is adopting a new policy associated with the new proxy voting requirement under the Dodd-Frank Act that provides shareholders an advisory vote on golden parachutes. The Dodd-Frank Act generally requires public companies to provide a separate, non-binding shareholder vote to approve golden parachute arrangements with named executive officers when seeking shareholder approval of any merger, consolidation, acquisition or the sale of all or substantially all of their assets. However, under certain prescribed circumstances, a golden parachute arrangement would be exempt from this shareholder vote requirement. This exemption arises when a golden parachute arrangement was included in a company's disclosure on executive compensation **and** such compensation was subject to a say on pay vote. Under rules proposed by the SEC, such exemption would be available only if the foregoing disclosure of the golden parachute arrangement was made in accordance with new broader disclosure requirements of the proposed rules.

ISS will provide vote recommendations on a case-by-case basis on proposals to approve a company's golden parachute arrangement. ISS' vote recommendation is based on its evaluation of a fairly broad list of features contained in the subject golden parachute arrangement. In contrast, ISS' assessment of golden parachute arrangements in the context of a say on pay vote resolution is based on its consideration of a fairly short list of "egregious" pay practices. Features contained within a golden parachute arrangement that may lead to an ISS vote recommendation AGAINST the golden parachute arrangement include the following items:

Problematic Features – Golden Parachute Arrangements	Meridian Observations
<ul style="list-style-type: none"> ■ Recently adopted or materially amended agreements that include excise tax gross-up provisions (since prior annual meeting) 	<p><i>Generally, this item is consistent with but somewhat broader than ISS' policy on egregious pay practices that directly impact ISS vote recommendations on say on pay resolutions. This item covers new agreements and agreements that have been "materially amended" in any manner. In contrast, ISS policy on egregious pay practices covers new agreements and agreements that have been amended to extend their term (other material amendments are not considered under the egregious pay practice policy).</i></p>
<ul style="list-style-type: none"> ■ Recently adopted or materially amended agreements that include modified single triggers (since prior annual meeting) 	<p><i>This item is consistent with, but also somewhat broader than, ISS' policy on egregious pay practices that directly impact ISS vote recommendations on say on pay resolution (see discussion above). This item should rarely be implicated because the inclusion of modified single triggers in a severance or employment agreement is rapidly diminishing practice.</i></p>
<ul style="list-style-type: none"> ■ 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 	<p><i>This item is consistent with ISS' policy on egregious pay practices with respect to single trigger payment of cash severance benefits. The inclusion of single trigger acceleration of performance-based equity awards and cash awards as a problematic feature is not covered under ISS' egregious pay practice policy and will likely cover a broad range of common acceleration features found in CIC severance agreements.</i></p> <p><i>Whether every type of accelerated payment (e.g., pro-rata payment of performance award) is subject to this new policy item requires clarification from ISS.</i></p>
<ul style="list-style-type: none"> ■ Single-trigger vesting of equity based on a definition of change in control that requires only shareholder approval of the transaction (rather than consummation of the transaction) 	<p><i>This item is not part of ISS' policy on egregious pay practices. However, it is a fairly uncommon practice among large companies and therefore, should rarely be implicated.</i></p>

Problematic Features – Golden Parachute Arrangements	Meridian Observations
<ul style="list-style-type: none"> Potentially excessive severance payments 	<p><i>ISS does not expressly define the term “excessive” severance payments. Additionally, the concept of excessive severance payments is not explicitly covered by ISS’ policy on egregious pay practices. However, ISS does consider severance payments in excess of 3 times base and bonus to be an egregious pay practice. It seems likely that ISS would also consider that level of severance payments to be “excessive” for purposes of determining its vote recommendation on a golden parachute arrangement. ISS might also consider the value of other benefits provided upon a CIC including the value of accelerated performance based and non-performance based awards. The definition of “excessive” severance payments requires additional clarification by ISS.</i></p>
<ul style="list-style-type: none"> 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 	<p><i>This item is not part of ISS’ policy on egregious pay practices. It is unclear the manner in which ISS will make the subjective determination required under this item.</i></p>
<ul style="list-style-type: none"> In the case of a substantial gross-up from pre-existing/grandfathered contract: the element that triggered the gross-up (e.g., option mega-grants at low point in stock price, unusual or outsized payments in cash or equity made or negotiated prior to the merger) 	<p><i>This item is not part of ISS’ policy on egregious pay practices. Based on the examples given in the policy update, few large companies should find this item of concern.</i></p>
<ul style="list-style-type: none"> The company’s assertion that a proposed transaction is conditioned on shareholder approval of the golden parachute advisory vote. ISS views this as problematic from a corporate governance perspective 	<p><i>This item is not part of ISS’ policy on egregious pay practices. However, it seems highly unlikely that a public company would condition a proposed transaction on shareholder approval of the company’s golden parachute compensation; especially because such approval is advisory and non-binding.</i></p>

In cases where a say on pay vote will cover a company’s golden parachute arrangements thereby exempting the arrangements from a future say on golden parachute vote, ISS will evaluate the golden parachute arrangement in accordance with the foregoing guidelines which are more comprehensive than ISS policy on egregious pay practices. Assuming the SEC proposed rules are adopted on say on golden parachute votes, companies will need to decide whether it is preferable to seek shareholder approval of their golden parachute arrangements in the context of their say on pay vote or in the context of a vote expressly on its golden parachute arrangements.

* * * * *

The **Client Update** is prepared by Meridian Compensation Partners’ Technical Team led by Donald Kalfen. Questions regarding this Client Update or executive compensation technical issues may be directed to Donald Kalfen at 847-235-3605 or dkalfen@meridiancp.com.

This report is a publication of Meridian Compensation Partners, LLC, provides general information for reference purposes only, and should not be construed as legal or accounting advice or a legal or accounting opinion on any specific fact or circumstances. The information provided herein should be reviewed with appropriate advisors concerning your own situation and issues.

www.meridiancp.com