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ISS Issues 2012 Policy Updates

Institutional Shareholder Services (ISS), an influential proxy advisory firm, annually updates the policies that underlie its voting recommendations to its institutional investor clients. On November 17, 2011, ISS issued its policy updates applicable to shareholder meetings occurring on or after February 1, 2012. The updates include a revised pay-for-performance model and details about the heightened scrutiny ISS will employ if the prior year advisory vote to approve executive compensation (say-on-pay) received less than 70 percent support. The policy updates generally are consistent with the draft policy changes issued by ISS for comment in October 2011.

This memorandum describes the key corporate governance and executive compensation policy updates applicable to publicly traded U.S. companies. The policy updates, along with other documents related to ISS voting guidelines, may be viewed in full at http://www.issgovernance.com.

Depending on a company's shareholder base, the recommendations of ISS can have a significant impact on the outcome of items submitted to a shareholder vote. Therefore, as proxy season approaches, companies should evaluate the potential ramifications of the policy updates on their 2012 say-on-pay proposals and anticipated support for directors, and determine whether and how to address any anticipated negative ISS recommendations. Any outreach to ISS and institutional shareholders ideally should take place by early 2012, as parties will be time constrained during proxy season and because, as described below, companies may find it beneficial to describe these outreach efforts in their proxy statements.

The topics subject to key changes or additions under the ISS policy updates for the 2012 proxy season, discussed in more detail below, include the following:

- evaluation of executive pay;
- company response to the prior year say-on-pay vote;
- company response to the prior year "frequency" vote (whether future say-on-pay votes should be held every one, two or three years);
- proxy access; and
- incentive plans and tax deductibility proposals under Section 162(m) of the Internal Revenue Code.

Evaluation of Executive Pay

ISS has adopted a new methodology for evaluating a company's pay-for-performance alignment, in order to determine whether to recommend a vote in favor of the company's say-on-pay proposal.

Under its existing policy, ISS evaluates whether a company's one-year and three-year total shareholder returns (TSR) are in the bottom half of its Global Industry Classification Standard (GICS) industry group, and whether the total pay of a CEO (who has served at least two consecutive fiscal years) is aligned with the company's TSR over time. Generally, if both one- and three-year TSR are below median and there has not been a meaningful year-over-year reduction in CEO pay (*e.g.*, 10 percent or more),

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the company is considered to have a pay-for-performance disconnect. This subjects the company's overall executive compensation program to greater scrutiny and raises the likelihood that ISS will recommend "against" the company's say-on-pay proposal.

Under the new policy, ISS will continue to conduct an annual pay-for-performance analysis but will consider *both* peer group alignment and absolute alignment, as follows:

- *Peer Group Alignment* – ISS's peer group alignment analysis will consider: (i) the degree of alignment between the company's TSR rank and the CEO's total pay rank within a peer group, as measured over one-year and three-year periods (weighted 40% and 60 percent, respectively), and (ii) the multiple of the CEO's total pay relative to the peer group median. The peer group for ISS's pay comparison will be the same as the TSR calculations peer group, generally consisting of 14-24 companies (as opposed to 8-12 under the current policy). These companies will be selected based on size using market cap, revenue (or assets for financial firms) and GICS industry group.

- *Absolute Alignment* – ISS's absolute alignment analysis will consider the absolute alignment between the trend in CEO pay and company TSR over the prior five fiscal years. The policy update describes this as the difference between the trend in annual pay changes and the trend in annualized TSR during the period.

If the analysis above demonstrates what ISS describes as significant unsatisfactory long-term pay-for-performance alignment, ISS will look to the following qualitative factors to determine how various pay elements may work to encourage or to undermine long-term value creation and alignment with shareholder interests:

- the ratio of performance-based to time-based equity awards;
- the overall ratio of performance-based compensation to overall compensation;
- the completeness of disclosure and rigor of performance goals;
- the company's peer group benchmarking practices;
- actual results of financial/operational metrics, such as growth in revenue, profit, cash flow, etc. both absolute and relative to peers;
- special circumstances related to, for example, a new CEO in the prior fiscal year or anomalous equity grant practices (*e.g.*, biennial awards); and
- any other factors deemed relevant.

The information provided about the updated evaluation of executive pay policy did not address whether prior year equity awards will continue to be assessed based on grant date fair value regardless of subsequent changes in equity value. The updated policy did clarify, however, that a new CEO will not exempt a company from evaluation under the new methodology. Further guidance on new approaches for evaluating pay-for-performance and selecting peer groups will be provided by ISS in December.

Company Response to Prior Year Say-on-Pay Vote

The policy update clarifies that ISS will employ a higher level of scrutiny when determining its vote recommendations regarding say-on-pay proposals and the re-election of compensation committee members (or, in exceptional cases, the full board) where the prior say-on-pay vote outcome received the support of less than 70 percent of the votes cast. This higher level of scrutiny will take into account the following:

- the company's response to concerns raised by shareholders in the previous year, including disclosed engagement efforts with major institutional investors regarding the issues that contributed to the low level of support and specific actions taken to address the issues that contributed to the low level of support;
- the company's ownership structure; and
- whether the issues raised are recurring or isolated.

ISS indicates that where the support level for the prior say-on-pay vote was less than 50 percent, it will expect companies to have exhibited the highest level of responsiveness. The rationale provided by ISS for this policy update emphasizes that companies should avoid "boilerplate" disclosure, and that the specific actions that companies take to address the issues that resulted in significant opposition votes should be new actions rather than a reiteration of existing practices.

ISS has established a process to engage with company representatives that is described on its website, and includes FAQs such as with whom ISS engages and what an issuer can expect in an ISS meeting (*see* http://www.issgovernance.com/policy/EngagingWithISS).

Company Response to Prior Year Frequency Vote

ISS will recommend "against" or "withhold" votes from the entire board (except new nominees, who will be considered on a case-by-case basis) if the board implements a frequency vote that is less than the frequency that received a majority of the votes cast.

ISS will recommend votes on a case-by-case basis on the entire board if the board implements a frequency vote that is less than the frequency that received a plurality (but not majority) of the votes cast, taking into account the following:

- the board's rationale for selecting its frequency vote;
- the company's ownership structure and vote results;
- ISS's analysis of whether there is a history of problematic compensation practices or compensation concerns; and
- the previous year's support level on the company's say-on-pay proposal.

Proxy Access

Under its new policy, ISS will evaluate management and shareholder proxy access proposals on a case-by-case basis when making a vote recommendation, taking into account company-specific and proposal-specific factors including:

- the proposal's minimum share ownership threshold;
- the proportion of directors that shareholders could nominate under the proposal; and
- the proposed method of determining which nominations should appear on the ballot if multiple shareholders submit nominations.

ISS no longer cites the proponent's rationale as one of the enumerated core factors it will consider when making its recommendations, although it may still be considered as one of numerous, but

unspecified, other factors (these other factors also may include the binding or precatory nature of a shareholder proposal). ISS noted in its policy update that "the access debate is fluid" and it expects a variety of proposals to be made in coming months. In addition, ISS's executive summary of the updates indicates that "[i]n January 2012, as part of our policy update process, ISS expects to provide additional guidance (via FAQs and/or through other reports) based on an examination of the specific proposal texts."

Incentive Plans and Tax Deductibility Proposals

ISS formalized a clarification it issued earlier in 2011 regarding its policy related to voting recommendations on proposals by newly public companies to approve equity (and executive incentive bonus) plans. As opposed to ISS generally recommending a vote for a proposal the first time that a company presents such a plan on its ballot for shareholder approval (for purposes of Section 162(m) of the Internal Revenue Code), the plan will be given a full equity plan evaluation.

ISS generally will recommend "for" proposals to approve or amend executive incentive plans if the proposal:

- only includes administrative features;
- places a cap on the annual grants any one participant may receive to comply with the provisions of Code Section 162(m);
- adds performance goals to existing compensation plans to comply with the provisions of Code Section 162(m) unless they are clearly inappropriate; or
- covers cash or cash and stock bonus plans that are submitted to shareholders for the purpose of exempting compensation from taxes under the provisions of Code Section 162(m) if no increase in shares is requested.

ISS generally will recommend "against" such proposals if:

- the compensation committee does not fully consist of independent outsiders; or
- the plan contains excessive problematic provisions.

Lastly, ISS generally will recommend "case-by-case" on such proposals if:

- in addition to seeking Code Section 162(m) tax treatment, the amendment may cause the transfer of additional shareholder value to employees; or
- a company is presenting an equity plan to shareholders for Code Section 162(m) favorable tax treatment for the first time after the company's initial public offering.

The rationale provided by ISS for this update included that the policy aligns with the recently proposed Treasury rule related to Code Section 162(m), which would require newly public companies to obtain shareholder approval before awarding certain performance-based restricted stock units to named executive officers before the end of the standard post-IPO transition period in order for them to qualify as performance-based compensation. The proposed Treasury regulation was published in the Federal Register on June 24, 2011.

Other Matters

ISS changed its policies regarding a number of other matters, including:

- *Board Accountability/Governance Failures* – expanding the factors it will consider in recommending "against" or "withhold" votes from individual directors, members of a committee, or the entire board, to include failures of "risk oversight" to the list;
- *Dual-Class Structure* – adopting a policy to vote against proposals to create a new class of common stock (regardless of voting rights), unless there is a compelling rationale for the dual-class capital structure, the new class is intended for financing purposes with minimal or no dilution to current shareholders, and the new class is not designed to preserve or increase the voting power of an insider or significant shareholder;
- *Political Spending and Lobbying Activities* – updating its position on proposals calling for additional disclosure regarding lobbying activities (still a case-by-case analysis, but expanding its reach to all lobbying activities) and corporate political spending (generally a recommendation to vote for the proposal);
- *Exclusive Venue Management Proposals* – voting on a case-by-case basis on management proposals to establish an "exclusive venue" for shareholder litigation, taking into account whether the company has in place "good governance" features and whether the company has disclosed any "material harm" caused to it by shareholder litigation in other jurisdictions (but does not state what types of material harm could impact its evaluation); and
- *Hydraulic Fracturing* – adopting a policy generally to recommend in favor of proposals requiring disclosure of a company's natural gas hydraulic fracturing activities, with specific recommendations focusing on current disclosure practices and operating activities, past incidents or related litigation, and industry and regulatory developments.