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ISS 2012 US Policy Updates

Dear Friends:

As previewed in our last [Georgeson Report](#), dated October 28, 2011, Institutional Shareholder Services (ISS) has released its voting guideline updates for the 2012 proxy season, effective for meetings on or after February 1, 2011. In this report, we will discuss the key changes and their impact on you.

It comes as no surprise that for this year's policy changes, the say-on-pay issue takes center stage - with policy updates on the topics of board response to management say-on-pay, say-on-pay frequency vote, and the framework for evaluating executive management say-on-pay proposals. The proxy access proposal is another key issue of interest. There are also several policy updates on social and environmental issues, mainly representing slight modifications of ISS's existing policies or codification of ISS' existing approach to emerging new issues.

Board Response to Management Say-on-Pay Vote

Following the first year of the Dodd-Frank Act mandated say-on-pay vote, one of the key questions has been ISS's position on what level of "against" votes (i.e. the "red zone") on the say-on-pay proposal from the previous year would warrant board action on a company's compensation practices. And if a response is warranted, what kind of response ISS would consider acceptable. In adopting its policy position on board responsiveness, ISS is taking a case-by-case approach for its recommendation on compensation committee members, taking into account the level of opposition, the company's ownership structure, shareholder outreach efforts, specific actions taken by the company, and existing compensation concerns (whether one-off or recurring in nature). As we predicted in our last Georgeson Report, ISS has now specified that a threshold level of greater than 30 percent opposition to the company's previous say-on-pay vote would trigger additional scrutiny, with the highest degree of board responsiveness expected in cases of the failed say-on-pay votes that received less than 50 percent of the votes cast.

How Would the Policy Impact You?

For issuers whose last year's say-on-pay vote received support of less than 70 percent of the votes cast, it could be important to demonstrate that they have engaged in shareholder outreach efforts, and to disclose those efforts in their proxy statements. Also, in certain cases, to avoid a negative recommendation from ISS on compensation committee members, substantive changes to compensation practices may be warranted. The kinds of compensation changes that a company should consider will depend on any prior or current compensation issues of concern, the level of shareholder opposition to previous say-on-pay vote and feedback from shareholder outreach. For companies that had a failed say-on-pay vote, the absence of specific and meaningful action to address what could appear to be an ongoing concern may cause ISS to issue an adverse recommendation on the compensation committee members. We note that when say-on-pay was voluntary, the referendum vote, in part, was viewed as a means of avoiding votes in opposition to the election of compensation committee members. However, for companies that fared poorly in the pay referendum, it appears that directors will not be protected if they are not responsive.

Board Response to Management Say-on-Pay Frequency Vote

On the issue of board responsiveness to another Dodd-Frank Act mandated proposal, the management say-on-pay frequency vote, ISS has adopted a policy that would cause it to:

- > Issue "withhold/against" vote on incumbent director nominees if the board implements a less frequent say-on-pay vote than the frequency that received the majority of the votes cast; and
- > Vote on a case-by-case basis if the board implements a less frequent say-on-pay vote than the frequency that received a plurality but not the majority, of the votes cast. In its evaluation, ISS will consider factors like the board's rationale, the company's ownership structure, compensation concerns and the level of support on the say-on-pay proposal.

How Would the Policy Impact You?

The impact of this policy should be minimal as few companies have adopted a frequency that is out of line with the shareholder vote, with less than one percent of the companies having chosen to implement a frequency that differs from the frequency most supported by the shareholders. As the 2011 proxy season progressed, companies increasingly gravitated towards annual frequency, seemingly in response to institutional shareholders' and proxy advisory firms' policy position advocating annual votes. Likely for some of the same considerations of avoiding a negative reaction, the companies have been adopting the frequency most supported by shareholders, making this policy issue a rare occurrence.

Evaluation of Management Say-on-Pay Proposals

In the most important policy change for this year, ISS has revised its pay-for-performance analytical framework. Instead of the current focus on the year-over-year change in CEO's pay, ISS will evaluate the alignment between a CEO's pay and Total Shareholder Returns (TSR) over an extended period. A quantitative analysis, which may be followed by a qualitative review, will include three factors in two categories:

1. Relative Alignment - Two factors that will be analyzed are:
 - > The degree of alignment between the company's TSR rank and the CEO's pay rank within the peer group over one- and three-year periods (weighted 40/60, to place greater emphasis on the longer-term);
 - > The multiple of the CEO's total pay relative to the peer group median.

Note that the peer group will consist of 14 to 24 companies closest to the company in market cap, revenue (or assets) and GICS industry group.

2. Absolute Alignment - Alignment between the trend in the CEO's pay and the company's TSR over the prior five fiscal years.

Further qualitative analysis, as warranted for companies with weak pay-for-performance alignment, will include a review of the degree to which equity awards and compensation are performance-based (as opposed to time-based), disclosure and rigor of performance goals, peer group benchmarking practices, actual results of financial/operational metrics and any other special circumstances or relevant factors.

How Would the Policy Impact You?

We view the modifications as potentially helpful to companies that have had difficulty in meeting ISS guidelines based on an analysis of short-term pay-for-performance metrics, although we continue to be concerned about the heavy reliance on a single metric - total shareholder returns - as a proxy for performance. In the revisions, ISS seems to be addressing some of the more common criticisms that it has received this past year relating to its methodology in assessing pay-for-performance alignment.

While ISS has been using a narrower peer group in making CEO's pay comparisons, ISS now plans to use a more comparable and smaller peer group in assessing TSR performance. Thus far, ISS has used a broader four-digit GICS group in determining whether a company's TSR ranked below or above the median, and such a peer group often included companies with businesses that had little in common with that of the company being analyzed. With this change, gaining an understanding of ISS's peer group becomes more important. ISS plans to release a white paper by mid-December that would detail its peer group methodology. Also, ISS often issues further interpretations of its methodology in "FAQs" documents, usually in January, that may provide further guidance. This may allow a company to guesstimate its possible peer group although the final peer group, would likely become known only at the time of release of ISS's proxy research report.

Under the current policy, in looking at changes in a CEO's pay only from the previous fiscal year, ISS seemed to place undue emphasis on the short-term. As an update to its policy, looking at the CEO's total pay rank and TSR rank over one-year and three-year periods could, therefore, be a positive change. Incorporating the absolute factor, measuring the alignment between the company's five-year TSR and the trend in the CEO's pay, as part of the quantitative analysis provides for an overall improved and more robust pay-for-performance test.

A shift away from using the existing one- and three-year TSR underperformance test and year-over-year change in CEO's pay to identify possible pay-for-performance disconnect by ISS means that the companies will be less certain as to whether or not they fail the quantitative test triggering further qualitative analysis. The companies should, however, take advantage of the longer-term focus by ISS, perhaps, by emphasizing pay-for-performance linkage in the CD&A in a time-frame that more closely matches the new ISS guidelines. The companies should also look to demonstrate how their short-term and long-term incentive compensation is tied to their business strategies. In drafting their CD&A disclosure, the companies may consider creating new charts and tables that make it easier for ISS and institutions to apply the new methodology.

Proxy Access Proposals

The SEC's decision to lift the stay on Rule 14a-8 following the D.C. Circuit Court's decision to strike down the mandatory proxy access rule, Rule 14a-11, has led to shareholder proposals on proxy access for the upcoming season. ISS is adding a few additional factors to its existing case-by-case policy that currently considers the ownership threshold and the proponent's rationale for such proxy access proposals.

ISS will consider factors such as the existence of any limit in the proposal on the maximum number of directors that can be nominated each year, and the method of determining which nominations get included on the ballot in case of multiple shareholders nominations. The updated policy will also be used to evaluate management proposals which may appear in 2012 as well.

How Would the Policy Impact You?

The additional factors in the policy update are meant to address some of the concerns raised with respect to providing safeguards and implementation of the proxy access nominations in these shareholder proposals. When these shareholder proposals were last seen on the ballot in 2007, ISS had indicated that the use of the proposed nomination process potentially being used as a back-door to a change in control is an important issue to consider. Given this concern about change in control, shareholder proposals this year have seen the inclusion of a cap on the number of directors that can be nominated in any given year, a provision also consistent with SEC's last proposed rule. As for the key issue of minimum ownership and the duration of ownership thresholds, as expected, ISS has avoided taking a position at this time. All but one of the 13 proxy access resolutions for 2012 proxy season made public as of December 12, thus far, have proposed thresholds that are more permissive compared to the SEC's universal access rule which would have required investor groups to hold a three percent stake for at least three years. The low-threshold proxy access proposals have been filed by retail shareholder activist Ken Steiner at five companies, by Norges Bank Investment Management (NBIM) at six companies, and by shareholder activist Jim McRitchie at one company. Steiner's and Jim's resolutions have proposed a one-percent-for-two-year ownership qualification while NBIM proposals call for a minimum stake of one percent for at least one year. ISS's position on ownership thresholds may become clearer only when it comes out with its analysis on the few initial shareholder proposals. However, note that in its comment letter to the SEC on proxy access issue, ISS supported all the different thresholds that SEC was considering that included more permissive standards than the SEC's final proposed three-percent-for-three year rule. ISS has also indicated that in considering the company-specific factors, it would look at the size and ownership structure of the shareholder base at the target companies.

Exclusive Venue Management Proposals

The 2011 proxy season saw a novel management proposal to make the state of a company's incorporation the exclusive forum for certain disputes. ISS adopted its current approach during the past season to recommend against the proposal unless the company had an annually elected board, a majority vote standard for uncontested election of directors, a shareholder right to call a special meeting and the absence of a poison pill unless approved by the shareholders. As an update to the approach, ISS is moving to a case-by-case policy on this issue and will assess whether the company has been harmed by shareholder litigation outside its jurisdiction of incorporation as an additional consideration (while also removing the right to call a special meeting as a factor). All the proposals in 2011 were to make Delaware the exclusive forum. If proposals to make another jurisdiction as the exclusive venue are to appear in 2012, ISS may also evaluate that jurisdiction's statutes, case law and judiciary as part of its analysis.

How Would the Policy Impact You?

By making its policy case-by-case and adding a company's litigation history as a factor in its analysis, ISS is placing the burden on the company to demonstrate how out-of-state litigation has negatively impacted it, something that may be hard to do. Under its current approach, ISS had recommended against all the three proposals that appeared in 2011. However, two of the three proposals passed despite ISS's "against" recommendation. Therefore, an assessment of the company's shareholder base along with an active shareholder outreach would be important if an issuer were to consider putting forth this proposal.

Authorization to Sell Shares of Common Stock at a Price Below Net Asset Value

ISS is codifying its policy on proposals by business development companies to seek shareholder authorization to sell shares of common stock at a price below Net Asset Value (NAV). In addition to the factor in line with the SEC regulation that requires the authorization to have an expiry period of one year from the date of shareholder approval, ISS policy stipulates support for the proposal if a majority of disinterested independent directors are in favor of such an issuance and the company has used shares responsibly in the past. ISS will determine responsible use of shares issuance based on either company's outperformance of its peers as measured by one- and three-year median TSRs or proxy disclosure that indicates small or moderate dilution from the past share issuances.

How Would the Policy Impact You?

Business development companies looking to seek authorization to sell shares below NAV should check to see how their TSR performance compares with those of its peers. They should also look to provide, especially if they underperform the peers on both one- and three-year TSR basis, information on their past share issuances that may have provided small discounts to NAV resulting in only limited economic dilution to existing shareholders. It only stands to reason that companies issuing shares at a discount would have underperformed on a TSR basis. Therefore, success in winning ISS's support may ride on explaining the urgent need for capital infusion and comparison with similar transactions to assess reasonableness.

Political Contribution Proposals

ISS is changing its current "case-by-case" approach to a "generally vote for" recommendation on political contribution proposals, which account for nearly one-third of the environmental and social proposals. Additionally, the disclosure of oversight mechanisms will now be explicitly noted as a factor in its policy guidelines. ISS policy would be to generally recommend a vote for proposals requesting greater disclosure of a company's political contribution and trade association activities. The analysis would consider the company's current disclosure policies and oversight mechanisms and any concerns related to the company's political contribution activities.

How Would the Policy Impact You?

The policy update seems more of an editorial change and will have little impact on ISS's recommendations. ISS has mostly been supportive of such proposals recommending in favor of approximately 88 percent of around 40 proposals that have appeared on the ballot this year. In order to get ISS to recommend against these proposals that saw average support at around 30 percent level, the companies would need to provide enhanced disclosure. A review of the disclosure by the few companies that saw ISS recommending with management on this issue can be illustrative.

Hydraulic Fracturing Proposals

ISS currently does not have a separate policy for Hydraulic Fracturing-related shareholder proposals; an issue that saw a strong 40.7 percent average support this past proxy season. ISS is adopting a policy that would generally recommend a vote for proposals requesting greater disclosure of a company's hydraulic fracturing operations, including mitigation measures the company may have taken. In its recommendation, ISS would consider the company's current level of disclosure, potential regulatory developments and existence of any controversial issues related to the company's hydraulic fracturing operations.

How Would the Policy Impact You?

ISS has recommended in favor of all of the five hydraulic fracturing proposals that have come to a vote thus far, which is in line with its stance to generally support greater disclosure. The policy, which essentially codifies ISS's existing approach, would therefore have little impact on ISS's recommendation practices. Perhaps the only way to convince ISS not to support such proposals is to demonstrate the depth of disclosure that may currently be available on the company's website. This factor, of course, could also apply to any E&S proposal in which disclosure is the key request contained in the resolution.

Incentive Bonus Plans and Tax Deductibility Proposals

ISS has generally been supportive of the equity plan proposal seeking tax deductibility under the provisions of Section 162(m) solely because of the benefits of the favorable tax treatment. However, for recent IPO companies where the equity plan is being put to the shareholder vote for the first time, ISS will now be using its full equity plan analysis to evaluate such plan proposals. ISS analysis will include consideration of shareholder value transfer, repricing, burn rate and liberal change in control definition.

How Would the Policy Impact You?

Since this policy change applies to only recent IPO companies, its impact will be limited. However, recently spun-off companies and those considering an IPO or spin-off of a business unit should make note of this change. ISS's analysis for AECOM Technology Corporation from the 2011 proxy season, the impetus for this policy update, is illustrative of ISS's updated approach.

Other Policy Changes

In addition to the above key changes, ISS has also updated its policies on a few other issues. Under its policy to recommend a vote against or withhold from directors in exceptional cases for reasons of governance failures, ISS is adding risk oversight as an explicit factor in line with the increased focus on this subject. On management proposal to create a dual-class structure, ISS is consolidating the factors into one policy and adding the issuer's rationale as an additional consideration in its vote recommendation. ISS is broadening the application of its existing policy on recycling proposals to now also apply to proposals requesting a report on a company's existing recycling programs, while also adding a company's current level of disclosure as a separate factor. ISS is adopting new policies on proposals relating to water safety reports and water-related risks that take into account a company's current level of disclosure, its risk exposure to the issue and existence of any recent problems. Finally, rounding-out the list of 2012 policy updates, ISS is clarifying that its policy to recommend against mutual fund proposals authorizing the board to hire and terminate sub-advisers without shareholder approval applies only if the investment adviser employs one sub-adviser.

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Georgeson has a team of experts who will continue to monitor these policy changes and other ongoing proxy matters. If you have any questions, please feel free to contact your Account Executive or any of the following Georgeson executives:

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