

## ISS Releases 2012 Updates to Proxy Voting Guidelines

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On November 17, Institutional Shareholder Services Inc. (ISS), a leading provider of corporate governance solutions to the global financial community, released its final 2012 updates to its proxy voting guidelines, which will be used by ISS in formulating its 2012 voting recommendations for publicly held companies with shareholder meetings on or after February 1, 2012. The key changes are discussed below.

### Proxy Access

On September 20, 2011, the Securities and Exchange Commission (SEC) adopted an amendment to Exchange Act Rule 14a-8(i)(8), under which a U.S. public company is generally required to include in its proxy materials shareholder proposals that either request the board to implement proxy access, or, if permitted under state law (as in Delaware), to amend the company's bylaws to implement proxy access. As a result, it can be expected that there will be a number of shareholder proposals along these lines in the coming proxy season and in future years.

In formulating its voting recommendations, ISS has traditionally evaluated shareholder proposals asking for open proxy access on a case-by-case basis. The ISS 2012 updates provide that ISS will continue to do so, taking into account both company-specific circumstances and the following factors:

- The ownership thresholds proposed in the resolution (i.e., percentage and duration);
- The maximum proportion of directors that shareholders may nominate each year; and
- The method of determining which nominations should appear on the ballot if multiple shareholders submit nominations.

ISS has broadened the scope of the policy to cover both shareholder proposals and management proposals.

### Board Accountability – Governance Failure

Under what it terms “extraordinary circumstances,” ISS’s policy is to recommend votes “against” or “withhold” from individual directors, members of a committee, or the entire board, due to the following factors:

- Material failures of governance, stewardship, risk oversight, or fiduciary responsibilities at the

company;

- Failure to replace management as appropriate; or
- Egregious actions related to a director's service on other boards that raise substantial doubt about his or her ability to effectively oversee management and serve the best interests of shareholders at any company.

The only change made by the ISS 2012 updates is the addition of an explicit reference to “risk oversight.” This update clarifies ISS's existing policy by highlighting the significance of risk oversight within the broader concept of directors' fiduciary responsibilities. ISS indicates that the intention of this update is not to penalize boards for taking prudent business risks or for exhibiting a reasonable risk appetite, but is instead intended to address situations where there has been a material failure in a board's role in overseeing the company's risk management practices.

### **Board Responsiveness – Response to Frequency of Advisory Vote on Pay Results**

In the recently ended 2011 proxy season, U.S. public companies were required by the Dodd-Frank Wall Street Reform and Consumer Protection Act to provide shareholders an advisory vote on whether the management say-on-pay proposal would be put to shareholders every one, two, or three years. The ISS 2012 updates address a board's response to this advisory vote on frequency as follows:

- If a company's board implements a frequency that is less than a frequency that received majority support, ISS will recommend votes “withhold” or “against” the entire board (except new nominees, who will be considered case by case).
- If a company's board implements a frequency that is less than a frequency that received a plurality support, but not majority support, ISS will determine on a case-by-case basis its voting recommendation with respect to the entire board, taking into account the board's rationale for its choice, the company's ownership structure and vote results, ISS's analysis of whether there are compensation concerns or a history of problematic compensation practices, and the level of support for the management say-on-pay proposal during the prior year.

### **Board Response to High Levels of Management Say-on-Pay Proposal Opposition**

Under the ISS 2012 updates, if a company received less than 70% support from all votes cast for its management say-on-pay proposal during the prior year, ISS will determine on a case-by-case basis its voting recommendations for the re-election of compensation committee members (or in rare cases where the full board is deemed responsible, all directors) and on the management say-on-pay proposal. In making its determination, ISS will take into account the following factors:

- The company's response, including the following:
  - Disclosure of engagement efforts with major institutional investors regarding the issues that contributed to the low level of support;
  - Specific actions taken to address the issues that contributed to the low level of support;
  - Other recent compensation actions taken by the company;
- Whether the issues raised are recurring or isolated;
- The company's ownership structure; and
- Whether the support level was less than 50%, which would warrant the highest degree of responsiveness.

## **Pay-for-Performance Evaluation**

ISS has traditionally evaluated a company's pay-for-performance standards by measuring total stockholder return (TSR) versus CEO pay. The 2012 release indicates that ISS is instituting a new methodology using a similar, but more detailed, analysis. Previously, ISS would evaluate the one- and three-year TSR compared to an industry peer group and then perform a qualitative analysis (including review of CEO pay) of those companies with a TSR below the median. Under the new methodology, ISS will conduct an annual pay-for-performance analysis to identify "strong" or "satisfactory" alignment between pay and performance over a sustained period. For companies in the Russell 3000 index, this analysis considers the following quantitative factors:

- Peer group alignment:
  - Alignment of TSR rank and CEO rank within an industry peer group over the prior one- and three-year periods (weighted 40/60);
  - Multiple of CEO pay to peer group median; and
- Absolute alignment – alignment of the trend in CEO pay versus the trend in TSR over the prior five years.

The peer group is generally composed of 14 to 24 companies that are selected on the basis of market cap, revenue (or assets for financial firms), and a Global Industry Classification Standard (GICS) industry group through a process designed to select peers that are closest to the subject company, and where the subject company is close to median in revenue/asset size. The relative alignment evaluation will consider the company's rank for both pay and TSR within the peer group (for one- and three-year periods) and the CEO's pay relative to the median pay level in the peer group.

If the above analysis demonstrates that a company has significant unsatisfactory long-term pay-for-performance alignment or, in the case of a non-Russell 3000 index company, has misaligned pay and performance as otherwise indicated, the company's executive compensation will be subjected to further qualitative review by ISS, which could lead to a negative recommendation on the "say-on-pay" proposal. The qualitative review considers the following factors:

- The ratio of performance-based to time-based equity awards;
- The 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 (both absolute and relative to peers), such as growth in revenue, profit, cash flow, etc.;
- Special circumstances related to, for example, a new CEO in the prior fiscal year or anomalous equity grant practices (e.g., biannual awards); and
- Any other factors deemed relevant.

## **Incentive Bonus Plans and Tax Deductibility Proposals – Post-IPO Companies**

On June 24, 2011, the Internal Revenue Service (IRS) issued a proposed ruling relating to Section 162(m) of the Internal Revenue Code, requiring recent IPO companies to obtain shareholder approval before awarding certain performance-based restricted stock units to named executive officers in order to qualify them as performance-based compensation.

In the ISS 2012 updates, ISS stated its policy regarding compensation plan proposals relating to Section 162(m) as follows:

- Generally recommend votes “for” proposals to approve or amend executive incentive bonus plans if the proposal does one or more of the following:
  - Includes only administrative features
  - Places a cap on the annual grants any one participant may receive to comply with the provisions of Section 162(m)
  - Adds performance goals to existing compensation plans to comply with the provisions of Section 162(m) unless they are clearly inappropriate
  - 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 Section 162(m) if no increase in shares is requested
- Recommend votes “against” such proposals if either of the following factors are present:
  - The compensation committee does not fully consist of independent outsiders, per ISS’s director classification
  - The plan contains excessive problematic provisions.
- Determine its voting recommendations with respect to proposals regarding compensation plan proposals relating to Section 162(m) on a case-by-case basis if either of the following factors are present:
  - In addition to seeking 162(m) tax treatment, the amendment may cause the transfer of additional shareholder value to employees (e.g., by requesting additional shares, extending the option term, or expanding the pool of plan participants). Evaluate the Shareholder Value Transfer in comparison with the company’s allowable cap.
  - A company is presenting the plan to shareholders for Section 162(m) favorable tax treatment for the first time after the company’s IPO. Perform a full equity plan analysis, including consideration of total shareholder value transfer, burn rate (if applicable), repricing, and liberal change in control. Other factors such as pay-for-performance or problematic pay practices as related to management say-on-pay may be considered if appropriate.

The key change in the ISS 2012 updates is that, going forward, the first time a post-IPO company presents an equity plan for Section 162(m) approval, ISS will give the plan a full equity plan evaluation.

### **Other Changes**

The ISS 2012 updates also include the following changes:

*Exclusive venue management proposals.* ISS shifted its policy from recommending votes “against” exclusive venue management proposals to a case-by-case approach, taking into account the company’s litigation history and corporate governance features.

*Dual-class capital structure proposals.* With respect to proposals to add a new class of common stock, ISS shifted its policy from recommending votes “against” or “for” such proposals based on specific criteria to generally recommending votes “against” such proposals unless the company discloses 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 in both the short term and long term, and the new class is not designed to preserve or increase the voting power of an insider or significant shareholder.

*Hydraulic fracturing proposals.* Hydraulic fracturing, also known as fracking, is a natural gas extraction technique that involves the high-pressure injection of water, sand, and chemicals into a gas-bearing shale rock formation. The pressure creates or exposes fissures, which then are kept open by the sand that remains after the water and chemicals are removed, allowing the formerly inaccessible natural gas to flow to the well for extraction. This process has attracted public attention due to its potential environmental implications. In the ISS 2012 updates, ISS added a policy of generally recommending votes “for” proposals requesting greater disclosure of a company’s (natural gas) hydraulic fracturing operations.

*Recycling proposals.* ISS continues its case-by-case approach with respect to proposals to report an existing recycling program or adopt a new recycling program, but broadened the scope of the policy and added the company’s current disclosure of such programs as a factor in making its determination.

*Political spending proposals.* With respect to shareholder proposals requesting greater disclosure of a company’s political contributions, ISS has shifted its policy from a case-by-case approach to generally recommending votes “for” such proposals.

*Lobbying activities.* ISS continues its case-by-case approach with respect to proposals requesting information on a company’s lobbying activities, but has clarified the scope of the policy.

*Workplace safety.* ISS added a new policy of formulating voting recommendations on a case-by-case basis for requests for workplace safety reports, including reports on accident risk reduction efforts.

*Water issues.* ISS added a new policy of formulating voting recommendations on a case-by-case basis for proposals requesting a company report on, or that a company adopt a new policy on, water-related risks and concerns.

*Mutual funds – proposals authorizing the board to hire and terminate subadvisers without shareholder approval.* ISS continues its policy to recommend votes “against” proposals authorizing mutual fund boards to hire and terminate subadvisers without shareholder approval, but has clarified that the policy applies only if the investment advisor employs only one subadviser.

*Business development companies – authorization to sell shares of common stock at a price below Net Asset Value (NAV).* ISS added a policy to recommend votes “for” proposals authorizing business development company boards to issue share below Net Asset Value (NAV) if certain conditions are met.

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