

Site Requirements

"ISS Issues Updated Proxy Voting Policies for the 2012 Proxy Season"

Fulbright Briefing

Manuel G. Rivera and Mara H. Rogers

November 22, 2011

Overview

On November 17, 2011, Institutional Shareholder Services (ISS) issued updates to its proxy voting policies applicable for shareholder meetings on or after February 1, 2012. ISS is an independent proxy advisory firm that furnishes recommendations to institutional investors on how to vote on numerous proposals included in public company proxy statements. Due to ISS's prominence and wide reach among institutional investors, its recommendations can, depending upon the company's shareholder base, significantly impact the outcome of a shareholder vote, particularly in director elections.

This *Fulbright Briefing* examines ISS's policy updates concerning:

- proxy access shareholder proposals;
- board responses to completed say-on-pay and say-on-pay frequency votes;
- executive pay-for-performance evaluations; and
- disclosure of corporate political spending.

In preparing proposals to be voted on at 2012 shareholder meetings, public companies and their shareholders should consider how their proposals mesh with any of the proxy voting policies in ISS's extensive repertoire, and whether any changes to their proposals are advisable. ISS's policies may be viewed in full on ISS's website.

Proxy Access Shareholder Proposals

"Proxy access" refers to the ability of shareholders to include their own director nominees in the company's proxy statement and proxy card for a shareholders' meeting, along with the director candidates nominated by management. As such, proxy access is a tool that may be used by institutional shareholders and other shareholder activists to increase board accountability and influence corporate policy. As described in our previous *Fulbright Briefing*, the September 2011 effectiveness of amendments to the SEC's shareholder proposal rule, Rule 14a-8 under the Exchange Act, paved the way for eligible shareholders to submit proposals, for inclusion in companies' 2012 proxy statements, requesting the adoption of proxy access bylaws and other director election or nomination procedures.

Although we cannot predict how widespread proxy access bylaw shareholder proposals will be in the 2012 proxy season, shareholders and shareholder activist organizations have already begun to circulate these proposals. For example, on November 10, 2011, the United States Proxy Exchange, a non-profit organization dedicated to facilitating shareowner rights, published a precatory "Model Shareowner Proposal for Proxy Access," the stated purpose of which is "to ensure that long-term shareowners have a reasonable, but not necessarily easy, means for including board nominations in the proxy materials those corporations distribute." The design of this model shareholder proposal highlights two issues of concern to public companies:

- whether proxy access proponents will draft proposed bylaws for particular companies to be submitted for binding shareholder votes, or instead draft proposals as advisory resolutions for non-binding shareholder votes; and

- the reasonableness of the terms of proposed proxy access arrangements; for example, the minimum stock ownership thresholds that would qualify a shareholder to avail itself of proxy access.

ISS supports proxy access in principle, but intends to review proxy access proposals case-by-case in 2012. Its updated policy states that in evaluating proposals, it will take into account "company-specific factors" and "proposal-specific factors," including the ownership thresholds proposed in the resolution (i.e., percentage and duration of company stock ownership), the maximum proportion of directors that shareholders may nominate each year and the method for determining which nominations should appear on the ballot if multiple shareholders submit nominations. ISS will also consider other factors, such as the proponent's rationale for submitting the proposal, which ISS stated it had overemphasized in its former voting policy. Finally, ISS will apply these evaluation criteria not only to shareholder proxy access proposals, but also to proxy access proposals formulated by company management.

Public companies and their advocacy organizations have expressed concerns that the new policy fails to give guidance on the specific terms that ISS would view favorably or unfavorably in a proxy access proposal. In response, ISS stated in its commentary that it "expects to provide additional guidance (via FAQs and/or through other reports)" in January 2012, based on an examination of actual shareholder and management proposals.

Board Responses to Completed Say-on-Pay and Say-on-Pay Frequency Votes

Under the SEC's rules implementing Section 951 of the Dodd-Frank Act, a U.S. public company must conduct, at least once every three years, a shareholder advisory vote, known as a "say-on-pay" vote, to approve the compensation of its named executive officers, and conduct, at least once every six years, a separate shareholder advisory vote, known as a "say-on-pay frequency" vote, to approve the frequency—annual, biannual or triennial—of the company's say-on-pay votes. After these advisory votes are completed, the company's board of directors must decide whether or not to honor the prevailing view of its shareholders as expressed in the voting results.

2011 is the first year that most U.S. public companies have conducted mandatory say-on-pay and say-on-pay frequency votes at their annual shareholder meetings. The SEC amended Form 8-K to require public companies to report the results of the shareholder advisory votes in a Form 8-K and to disclose the board's subsequent decision regarding say-on-pay frequency in a Form 8-K amendment. Public companies will be required to discuss, in the Compensation Discussion and Analysis (CD&A) section of their 2012 proxy statements, whether and how the results of the 2011 say-on-pay vote factored into their compensation policies and decisions. In addition, ISS has adopted two new voting policies for 2012 that aim to further reinforce the say-on-pay and say-on-pay frequency viewpoints expressed by shareholders in completed advisory votes.

Say-on-pay. Under ISS's new policy, if the company's prior year say-on-pay proposal (for example, the say-on-pay proposal voted on at its 2011 annual meeting) received the support of less than 70% of the votes cast, ISS will recommend votes on a case-by-case basis with respect to:

- members of the company's compensation committee (or the full board of directors, in exceptional cases where responsibility for compensation concerns is attributable to the full board); and
- the company's current year say-on-pay proposal (for example, the say-on-pay proposal to be voted on at its 2012 annual meeting).

In determining its recommendation, ISS will, among other factors, assess the company's response to the unfavorable voting result, including:

- the company's disclosure concerning its outreach and engagement efforts with major institutional investors regarding the compensation issues that contributed to the low level of shareholder support;
- specific actions taken to address these issues;
- whether the issues raised are recurring or isolated;
- the company's other recent compensation actions;

- the company's ownership structure; and
- whether the support level was less than 50% (which should invoke the highest level of company response).

The policy encourages companies to avoid boilerplate and instead provide specific disclosure as to actions undertaken by the board to address the compensation concerns that led to a significant level of shareholder opposition to the say-on-pay proposal.

Say-on-pay frequency. If the board implements a less frequent say-on-pay vote than the frequency that received a majority of the votes cast on the company's prior year say-on-pay frequency proposal, under its new proxy voting policy, ISS will recommend a vote against, or a withhold vote in respect of, all members of the board of directors, except new nominees (who will be considered on a case-by-case basis). If the board implements a less frequent say-on-pay vote than the frequency that received a plurality of the votes cast (where no option received a majority of the votes cast) on the company's prior year say-on-pay frequency proposal, ISS will issue recommendations with respect to director voting on a case-by-case basis, taking into account such factors as:

- the board's rationale for implementing a less frequent say-on-pay vote than desired by the shareholders;
- the company's ownership structure;
- compensation concerns; and
- the company's level of say-on-pay support from the previous year.

Executive Pay-for-Performance Evaluations

Aligning the pay of the chief executive officer with the company's performance is one of the most difficult issues on the regulatory agenda for public companies. The SEC is scheduled, by the end of the year, to propose executive compensation rules to implement Section 953 of the Dodd-Frank Act, including rules concerning disclosure of pay-for-performance and the ratio of CEO pay to the median pay of other employees.

ISS's previous methodology involved identifying pay-for-performance disconnects by scrutinizing underperforming companies (namely, those with one- and three-year total shareholder returns below the median of their Global Industry Classification Group (GICS)), and then applying a qualitative examination of other factors, including the year-over-year change in the CEO's total pay and a view of the five-year trends in company total shareholder return and CEO pay, to determine whether pay and performance are misaligned. Public companies and investors were critical of this methodology because it did not view pay-for-performance alignment for all companies in a long-term context, zoned in on companies with weak relative pay-for-performance alignment without identifying companies with strong pay-for-performance alignment, and did not provide an effective screen for companies that provide high CEO compensation while delivering mediocre relative long-term total shareholder returns.

In response to this feedback, ISS's 2012 proxy voting policies set forth a new approach to evaluating CEO pay, consisting of a quantitative analysis of both relative and absolute alignment of pay-for-performance, followed by a qualitative analysis. ISS will base its voting recommendations with respect to the company's advisory say-on-pay proposal on this new analytical framework.

Peer group (relative) alignment. The relative alignment analysis will:

- evaluate companies in the Russell 3000 stock index within groups of 14 to 24 peers of similar market capitalization, revenue (or assets for financial firms) and GICS;
- assess the degree of alignment between the company's total shareholder returns and the rank of the CEO's pay within the peer group over one-year (with a 40% weighting) and three-year (with a 60% weighting) periods; and
- review the multiple of the CEO's total pay relative to the peer group median.

Absolute alignment. The absolute alignment analysis will look at the alignment between the trend in CEO pay and the company's total shareholder returns over the past five fiscal years.

If the quantitative analysis described above demonstrates "unsatisfactory long-term pay for performance alignment" (or, in the case of companies not included in the Russell 3000 index, ISS determines that pay and performance are misaligned), ISS will review numerous qualitative factors that it deems relevant, such as the company's financial performance, extent of performance-based compensation, its disclosure concerning performance goals and its peer group benchmarking practices, to reach its final voting recommendation.

Public companies have raised a variety of questions regarding the new methodology. For example, they have voiced concerns as to whether appropriate peer groups will be selected and whether total shareholder return should be the primary metric in the quantitative analysis. In addition, companies currently have only limited visibility as to the workings of ISS's new methodology. ISS's commentary indicates that, to increase transparency, it will provide additional guidance on its pay-for-performance methodology in a technical document to be released in December 2011 and that it also will disclose its peer group methodology and rationale in several communications, "allowing institutional investors and issuers to understand how peer groups are constructed by ISS."

Disclosure of Corporate Political Spending

In 2010, the U.S. Supreme Court held in *Citizens United v. FEC* that the First Amendment of the U.S. Constitution protects corporations' freedom to spend corporate funds on indirect support of political candidates. Corporate decisions to engage in political speech are governed by the business judgment rule under state corporate law. However, numerous shareholders and special interest groups have advocated disclosure of political spending by public companies as a corporate governance best practice. This year, the Baruch College Robert Zicklin Center for Corporate Integrity unveiled an Index of Corporate Political Disclosure, which rates the largest public companies on their disclosure practices concerning political spending, and the Center for Political Accountability and the Wharton School's Zicklin Center for Business Ethics Research introduced its Corporate Political Disclosure and Accountability Index, which rates public companies for the quality of their political disclosure and accountability practices. In addition, in August 2011, the Committee on Disclosure of Corporate Political Spending, a group of prominent corporate and securities law professors, filed a petition for rulemaking with the SEC, requesting that the SEC develop rules to require public companies to disclose to shareholders the use of corporate resources for political activities.

Consistent with these recent developments seeking improved transparency, ISS has revised its proxy voting policy from a case-by-case review to a "generally vote FOR" position with respect to proposals requesting greater disclosure of a company's political contributions and trade association spending policies and activities. However, in reaching its voting recommendation, ISS will consider the company's current disclosure of policies and oversight mechanism, including its business rationale for supporting political organizations, and any recent significant controversies, fines or litigation related to the company's political activities.

This article was prepared by [Manuel G. Rivera](mailto:mgrivera@fulbright.com) (mgrivera@fulbright.com or 212 318 3296) and [Mara H. Rogers](mailto:mrogers@fulbright.com) (mrogers@fulbright.com or 212 318 3206) from Fulbright's **Securities** Practice Group.