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ISS Publishes 2012 Voting Policy Updates

Institutional Shareholder Services has published its 2012 updates to its voting policies, effective for meetings on or after February 1, 2012. As was the case in the last round of policy updates, focus remains on executive compensation and corporate governance issues. We highlight below the key changes affecting U.S. companies, but note that ISS also published amendments to its voting policies for Canada, Europe and other non-U.S. jurisdictions. For a copy of these policy updates, see http://issgovernance.com/policy/2012/policy_information

Board Response to High Levels of Opposition in the Say-on-Pay Vote. ISS has adopted a new policy in which it will recommend a vote on a case-by-case basis on compensation committee members (or the full board in exceptional cases) and on say-on-pay management proposals, if the company's previous say-on-pay vote was approved by less than 70% of votes cast, taking into account the following factors:

- The company's response to that vote, including:
  - Disclosure of engagement efforts with major institutional investors regarding the issues that contributed to the low level of support (e.g., whether disclosure is easily identifiable and made in a non-boilerplate fashion);
  - Specific (ideally new) actions taken to address those issues; and
  - 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.

As had been discussed by practitioners, this new policy solidifies the 70% approval level as a "best practices" floor for the say-on-pay vote, below which shareholders will expect some meaningful responses and possible compensation practice changes from the board.

Board Response to the Say-on-Frequency Vote. ISS has adopted a new voting policy that recommends a vote against or withhold from the entire board (except for new nominees who would be considered on a case-by-case basis) if the board implements a say-on-pay vote frequency that is less frequent than that approved by a majority of votes cast. Where the shareholders approve a say-on-pay frequency by a mere plurality, instead of a majority, ISS will recommend a vote on the board on a case-by-case basis if the board implements a say-

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on-pay frequency that is less than the frequency that received a plurality, taking into account the following factors:

- The board's rationale for selecting a frequency that is different from the frequency approved by a plurality;
- The company's ownership structure and vote results;
- ISS' analysis of whether there are compensation concerns or a history of problematic compensation practices; and
- The prior year's support level on the company's say-on-pay vote.

ISS notes that notwithstanding the fact that the say-on-frequency vote is nonbinding as a matter of law, it nevertheless views majority support of a particular say-on-pay vote frequency as a mandate to a board.

Say-on-Pay Proposals. ISS has amended its methodology for determining pay-for-performance alignment so as to provide a clearer view of the relationship between executive compensation and company performance. ISS now specifies that it will conduct an analysis which, with respect to the Russell 3000 companies, will consider the following factors:

- “Peer Group Alignment,” defined as the degree of alignment between the company's total shareholder return rank and the CEO's total pay rank within the ISS-identified peer group, as measured over one-year and three-year periods (weighted 40/60) and the multiple of the CEO's total pay relative to the peer group median, and
- “Absolute Alignment,” defined as the absolute alignment between the trend in CEO pay and the trend in company total shareholder return over the prior five fiscal years.

If the above analysis shows a potential long-term pay-for-performance disconnect, then ISS will examine the following additional factors to determine whether there is indeed such a disconnect:

- 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 and 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.

Proxy Access Proposals. As was the case with its 2011 voting policy, ISS continues to recommend votes on proxy access proposals on a case-by-case basis. However, ISS has expanded the policy to cover management proxy access proposals as well as shareholder proxy access proposals. ISS also added factors that it would consider in making its recommendation, including company specific factors and proposal specific factors, such as ownership thresholds (e.g., percentage ownership and holding period requirements), maximum proportion of possible shareholder nominees and how priority among shareholder nominees would be determined where multiple shareholders submit candidates.

Although investors had urged ISS to include more specific criteria with respect to this policy, ISS declined to do so at this point due to the possible breadth of variation among proxy access proposals. ISS did, however, indicate that it expects to provide additional guidance on this topic via FAQs or other reports in January 2012 based on an examination of specific proposals made for the upcoming proxy season. We note that two proxy access shareholder proposals–both submitted by the same retail investor at different companies–have been made public so far this year. Reports indicate that the proposals are based on a model posited by the United States Proxy Exchange (a retail shareholder advocacy group), which would allow shareholders owning 1% of the company's securities continuously for two years or any group of shareholders of whom 100 or more satisfy Rule 14a-8's minimal share ownership requirements (i.e., ownership of $2,000 of stock for one year) to nominate the greater of one director or up to 12% of the current board.

Incentive Bonus Plans and Tax Deductibility Proposals. ISS has expanded its policy on proposals to approve equity plans under Section 162(m) of the Internal Revenue Code to specify that it will recommend a vote on a case-by-case basis if:

- In addition to seeking Section 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), in which case ISS will evaluate the "shareholder value transfer" (i.e. the cost of the equity plans as calculated by ISS) in comparison with the company's allowable cap; or

- A company is presenting the plan to shareholders for Section 162(m) favorable tax treatment for the first time after the company's initial public offering, in which case ISS will perform a full equity plan analysis, including consideration of total shareholder value transfer, burn rate (if applicable), repricing and liberal change in control provisions. Other factors such as pay-for-performance or problematic pay practices may also be considered if appropriate.

In addition, ISS will generally recommend votes for or against proposals to approve or amend executive incentive bonus plans as follows:

- Recommend a vote for such proposals if the proposal:
    - Is only to include 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; 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 Section 162(m) if no increase in shares is requested; and
- Recommend a vote against such proposals if:
  - The compensation committee does not fully consist of independent outsiders, per ISS' director classification; or
  - The plan contains excessive problematic provisions.

Recently, there has been a renewed focus on the limitations under Section 162(m) on the deductibility of compensation in excess of $1,000,000 paid to a public company's CEO and the next three highest compensated executive officers (other than the CFO) who are listed in the Summary Compensation Table in the company's proxy statement or Form 10-K. The IRS recently proposed regulations "clarifying" that the general exception from the Section 162(m) limitation applicable to compensation granted during a special transition period for newly public companies does not apply in the case of grants of restricted stock units and phantom stock (in contrast to grants of stock options, stock appreciation rights and restricted property, for which the exception does apply). Additionally, there have been some recent shareholder derivative lawsuits alleging, among other things, that proxy disclosures regarding compensation for senior executives were false and misleading and that the compensation was not deductible under Section 162(m) (resulting in, for example, corporate waste and unjust enrichment). *As a result, particular attention should be paid to the design, administration, implementation and disclosure of plans and arrangements intended to comply with Section 162(m) and the applicable post-IPO transition period exemptive relief.*

Board Accountability. ISS has expanded its existing policy to recommend against or withhold votes from directors, committees or entire boards where there is a material failure of governance, stewardship or fiduciary responsibility at the company explicitly to cover material failures in risk oversight as well. ISS notes that this change is not meant to penalize boards for taking prudent business risks or for exhibiting reasonable risk appetite, but does not include any clarification as to what would constitute a material failure in risk oversight.

Environmental, Social and Governance Proposals. ISS has amended its existing policies and added several new policies in the broad category of so-called environmental, social and governance proposals generally to enhance their support for such proposals, as follows:

- The policy to recommend votes on a case-by-case basis on proposals to improve company disclosure of its political contributions and trade association spending has been amended to a policy generally to recommend votes for such proposals. The policy is also amended to factor in the company's existing disclosure of their oversight mechanisms related to such spending;

- The policy to recommend votes on a case-by-case basis on proposals requesting information on a company's lobbying initiatives has been amended to clarify that the policy applies to proposals seeking information on the company's lobbying activities generally (and not solely to its lobbying initiatives) and also adds broader grassroots lobbying activities;

- The policy to recommend votes on a case-by-case basis on proposals to report on a company's recycling program has been amended to factor in consideration of the company's current level of disclosure on the issue; and

- New policies generally to recommend votes for proposals requesting greater disclosure of a company's hydraulic fracturing operations or reports on workplace safety or water-related risks and concerns, after considering specified factors for each issue, have been added.

Exclusive Venue Management Proposals. ISS has changed its 2011 policy to recommend a vote against proposals seeking approval of exclusive venue charter provisions (unless certain corporate governance features are in place) to a recommendation to vote on a case-by-case basis. ISS also removed special meeting rights as one of the recommended corporate governance features and specified that it will consider whether the company has been materially harmed by shareholder litigation outside the jurisdiction of incorporation when making its vote recommendation.

Dual-Class Capital Structure Proposals. Whereas its 2011 voting policy hinged on whether a new class of stock being created had superior voting rights, ISS has consolidated its voting policy on dual-class capital structures into one policy that does not consider voting rights. In addition, ISS has added as a factor which it will consider in making its recommendation: whether the company discloses a compelling rationale for the dual-class capital structure, such as the company's auditor has concluded that there is substantial doubt about the company's ability to continue as a going concern or the new class of shares will be transitory.

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While ISS is, of course, a proxy advisory firm and typically not a direct shareholder or investor, its influence among institutional investors (particularly smaller institutional investors) is significant, and companies are well advised to review ISS's policies to see how significant issues, such as their executive compensation packages, would fare.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

David S. Huntington
212-373-3124
dhuntington@paulweiss.com

Lawrence I. Witdorchic
212-373-3237
lwitdorchic@paulweiss.com

John C. Kennedy
212-373-3025
jkennedy@paulweiss.com

Reuven Falik
212-373-3399
rfalik@paulweiss.com

Raphael M. Russo
212-373-3309
rrusso@paulweiss.com

Frances F. Mi
212-373-3185
fmi@paulweiss.com

NEW YORK
1285 Avenue of the Americas
New York, NY 10019-6064
+1-212-373-3000

BEIJING
Unit 3601, Fortune Plaza Office
Tower A
No. 7 Dong Sanhuan Zhonglu
Chao Yang District, Beijing 100020
People's Republic of China
+86-10-5828-6300

HONG KONG
12th Fl., Hong Kong Club Building
3A Chater Road
Central Hong Kong
+852-2846-0300

LONDON
Alder Castle, 10 Noble Street
London EC2V 7JU
United Kingdom
+44-20-7367-1600

TOKYO
Fukoku Seimei Building, 2nd Floor
2-2, Uchisaiwaicho 2-chome
Chiyoda-ku, Tokyo 100-0011
Japan
+81-3-3597-8101

TORONTO
Toronto-Dominion Centre
77 King Street West, Suite 3100
P.O. Box 226
Toronto, ON M5K 1J3
Canada
+416-504-0520

WASHINGTON, D.C.
2001 K Street NW
Washington, DC 20006-1047
+1-202-223-7300

WILMINGTON
500 Delaware Avenue, Suite 200
Post Office Box 32
Wilmington, DE 19899-0032
+1-302-655-4410