Wilson Sonsini Goodrich & Rosati
PROFESSIONAL CORPORATION

WSGR ALERT

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ISS ISSUES U.S. PROXY VOTING GUIDELINES FOR 2012

On November 17, 2011, Institutional Shareholder Services (ISS) released its 2012 proxy voting guidelines, which are effective for shareholder meetings on or after February 1, 2012. ISS is the leading proxy advisory firm in the United States, and academic and professional research suggests that a voting recommendation by ISS can change the outcome of a shareholder vote by 15 to 20 percent (or more). As a result, it is important for every public company to understand ISS's policies and how the company's practices measure up to those policies in order to take proactive steps related to anticipated or actual negative voting recommendations.

Executive Compensation Changes

Less than 70 Percent Approval of Say-on-Pay Vote

For the 2012 proxy season, ISS has revised its policies to provide that if a company receives less than 70 percent of its shareholders' approval on its previous advisory vote regarding say-on-pay, then ISS will analyze the company to see if negative vote recommendations are warranted. Specifically, ISS will analyze:

- the company's response to the previous advisory vote, including
  - disclosure of engagement efforts with major institutional investors regarding the issues that contributed to the "low" level of support,
  - specific actions taken to address issues contributing to the low level of support, and
  - other recent compensation actions;
- whether the issues raised are recurring or isolated;
- the company's ownership structure; and
- whether the support level was less than 50 percent, which would warrant the highest level of responsiveness.

Resulting negative vote recommendations may apply to compensation committee members, the board of directors (in exceptional cases), and the current say-on-pay proposal.

For companies that received less than 70 percent approval in their say-on-pay vote, the messaging in the proxy statement around the board of directors' response to the shareholders' dissatisfaction will be critical. Care should be taken to thoughtfully address the specific issues that contributed to the "low" level of support and the board's response to those issues. Ideally, the board's response will involve the adoption of new practices rather than a reiteration of existing ones.

It may come as a surprise to many companies that the approval of more than two-thirds of a company's shareholders (but less than 70 percent) could be viewed by ISS as a high level of opposition rather than a high level of approval. Some may view this as an attempt by ISS to respond to reports that its negative recommendations on say-on-pay proposals generated a swing in voting results of only 20 percent (e.g., from 90 percent to 70 percent support) in many cases. Be that as it may, this is now ISS's policy, and it does present some challenges for affected companies. Specifically, because say-on-pay is an up-or-down advisory vote, it may be difficult for companies to understand what specific compensation practices led to the so-called "high" level of opposition, thus making it difficult to respond in a manner that satisfies ISS.

CEO Pay-for-Performance Methodology Revised

For Russell 3000 companies, ISS analyzes CEO pay versus company performance to determine whether it will issue negative vote recommendations against:

- say-on-pay proposals;
- the re-election of the members of the compensation committee and, in exceptional cases, other board members; and
- equity plan proposals if non-performance-based equity awards are major contributors to a pay-for-performance misalignment.

Previously, ISS measured a Russell 3000 company's performance against all other Russell 3000 members of its four-digit Global Industry Classification Standard (GICS) group. If total shareholder returns over one- and three-year periods were below the median and CEO compensation was not significantly reduced, then ISS analyzed the company. Sometimes ISS found a disconnect between pay and performance, leading to negative vote recommendations.

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For 2012, ISS has revised its methodology in scrutinizing the alignment of CEO pay with corporate performance. Specifically, ISS has replaced the GICS group with a newly established (by ISS) peer group. A company's new peer group will consist of 14 to 24 companies that ISS will select after considering market capitalization, revenue (or assets for financial companies), and the GICS industry group. ISS will attempt to situate each company near the median of its peer group.

CEO pay and corporate performance (as measured by total shareholder return) will then be evaluated against the peer group over one-year (weighted 40 percent) and three-year (weighted 60 percent) time periods. The CEO pay ranking then will be compared to the company performance ranking. ISS also will analyze the multiple of CEO pay versus the peer group median. Finally, ISS will analyze what it calls "absolute alignment"—the difference between the trend in annual CEO pay and annualized total shareholder returns over a five-year period.

If the analysis demonstrates a significant pay-for-performance misalignment, or if such misalignment is otherwise discerned for non-Russell 3000 companies, then ISS will undertake a deeper analysis considering:

- 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 processes;
- actual results of financial or operational metrics, such as growth in revenue, profit, cash flow, etc., both on an absolute basis 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 ISS deems relevant.

The revised policy makes clear that companies with a new CEO also will be subject to scrutiny. It remains to be seen whether these revisions will result in more or fewer companies receiving negative vote recommendations from ISS based on a perceived CEO pay-for-performance misalignment.

162(m) Deductibility Approval

Newly public companies often seek shareholder approval of the material terms of their equity plans when their private-to-public exception under Internal Revenue Code Section 162(m), which limits the deductibility of certain executive compensation to $1 million per year, expires. This often happens in the fourth year after an initial public offering. In 2010 and prior years, ISS generally supported such proposals, even if the equity plan (i) contained an evergreen annual replenishment feature, (ii) allowed underwater option repricing without shareholder approval, or (iii) contained so-called liberal share counting provisions or a problematic change-of-control definition such that it would otherwise have flunked ISS's tests for equity plan proposals.

The new 2012 ISS guidelines codify a position informally taken in 2011 by ISS where there is no "free pass" for newly public companies with respect to such proposals. Instead, if a company's equity plan is being approved by its public shareholders for the first time, then the plan will be subject to a full-blown ISS equity plan analysis. As a practical matter, this may require companies to consider whether to sacrifice their evergreen annual replenishment feature (and other plan provisions) in order to maintain the deductibility of certain executive compensation.

Frequency of Say-on-Pay Vote

For 2012, ISS will recommend a vote against re-electing the entire board of directors (except new nominees) if the board implements an advisory vote on executive compensation on a less frequent basis than the frequency that received the *majority* of votes cast at the most recent shareholder meeting at which shareholders voted on say-on-pay frequency.

ISS will consider companies on a case-by-case basis if the board of directors implements an advisory vote on a less frequent basis than the frequency that received a *plurality*, but not a majority, of votes cast at the most recent shareholder meeting at which shareholders voted on say-on-pay frequency.

Because only a few companies adopted a different vote frequency than that voted for by a plurality of their shareholders, this new policy should have a limited effect.

Proxy Access

As we have discussed previously,[1] the Securities and Exchange Commission allowed amendments to Rule 14a-8 permitting eligible shareholders to include proposals regarding the adoption of proxy access procedures in a company's proxy statement to become effective in mid-September 2011. Most significantly, the amendments permit "private ordering" proxy access through the Rule 14a-8 shareholder approval process.

Certain shareholder groups have begun to urge retail investors to submit Rule 14a-8 shareholder proposals regarding proxy access.

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[1] For more information, please see our WSGR Alert available at http://www.wsgr.com/WSGR/Display.aspx?SectionName=publications/PDFSearch/wsgralert-proxy-access-decision.htm.

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On November 10, 2011, the U.S. Proxy Exchange, an organization supporting retail shareholder activists, released a model proxy access proposal. Rule 14a-8 proxy access proposals already have been submitted to at least two companies, with many more submissions expected during the 2012 proxy season.

For 2012, ISS will evaluate proxy access proposals—including those submitted by management—on a case-by-case basis. As part of this analysis, ISS will consider company-specific and proposal-specific factors, including:

- the ownership thresholds (including percentage and duration) in the proposal;
- 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.

Although the above factors are likely to be among the core features of proxy access proposals, they are not intended to be exhaustive in ISS's evaluation. It is notable that, as part of expanding and refining the factors that it will consider, ISS removed the proponent's rationale as a core factor for evaluation. That said, the proponent's rationale still may be considered as one of the unspecified "other" factors that ISS will consider.

Recognizing that the proxy access debate is fluid, ISS stated that its policy is designed to ensure flexibility in order to address the wide variety of approaches to the issue. ISS expects to provide additional guidance on proxy access proposals in January 2012 based on an examination of specific proposal texts.

Other Policy Changes

For 2012, ISS has expanded the factors that it will consider in recommending "against" or "withhold" votes from directors individually in uncontested elections to include material failures of risk oversight. Although ISS states that this policy change is not designed to "penalize" boards of directors that take prudent business risks or exhibit reasonable risk appetite, it is not clear how ISS will distinguish more fundamental and systemic shortcomings from prudent or reasonable risk-taking.

ISS also will shift to a case-by-case approach for proposals to establish an exclusive venue for shareholder litigation. As part of its evaluation, ISS will focus on whether the company (i) has in place "good governance" features (such as an unclassified board, majority voting in director elections, and the absence of a non-shareholder-approved poison pill) and (ii) has disclosed "material harm" caused to it by shareholder litigation in other jurisdictions.

For political spending proposals—which are expected to be plentiful during the 2012 proxy season—ISS now will generally recommend a "for" vote out of a desire to increase transparency on these issues. For policies on lobbying disclosure (including both direct and grassroots lobbying directed at the public), ISS will use a case-by-case approach that evaluates, among other things, the company's current disclosure of relevant policies and oversight mechanisms.

Finally, ISS has (i) consolidated the factors that it will consider on dual-class stock proposals and (ii) revised its voting policies on proposals related to certain social and environmental issues, such as hydraulic fracturing, recycling, workplace safety, and water issues.

Additional information regarding all of ISS's policy updates for 2012 is available at http://www.issgovernance.com/policy/2012/policy_information.

At 11:00 a.m. (EST) on December 7, 2011, ISS will host a webinar to discuss (i) its 2012 policy updates and (ii) the key corporate governance issues facing investors and companies in 2012. Additional information about this webcast is available at http://www.issgovernance.com/webinars/PolicyPerspectives2012.

For more information on these or related matters, please contact your regular Wilson Sonsini Goodrich & Rosati attorney or any member of the firm's corporate and securities or employee benefits and compensation practices.

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