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ISS Updates Proxy Voting Guidelines for 2012

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ISS has released its annual update to its proxy voting guidelines for the 2012 proxy season. The update reflects changes in ISS's pay-for-performance evaluation methodology, responses to say-on-pay votes and say-on-pay frequency votes and a number of social and environmental policies.

Institutional Shareholder Services Inc. (ISS) has issued its annual update to its proxy voting guidelines, which have important implications for companies preparing for the 2012 proxy season. The updated policies apply to shareholder meetings held on or after February 1, 2012. The annual update reflects changes in ISS's approach towards the evaluation of executive compensation, responses to say-on-pay votes and say-on-pay frequency votes and a number of new or updated social and environmental policies. The full text of the policy updates may be accessed here.

The 2012 updates require attention by issuers before the start of upcoming proxy season. An issuer that benefitted from a favorable ISS say-on-pay voting recommendation in 2011 may receive a negative ISS say-on-pay voting recommendation in 2012 despite no change to its corporate performance or executive pay program. At the same time, some issuers with total shareholder return performance less favorable than in 2011 may be able to secure a favorable ISS say-on-pay voting recommendation. To do so, it may be necessary to address additional corporate performance and executive pay matters for the first time in upcoming proxy statements. If an issuer secured less than seventy percent shareholder support for the 2011 say-on-pay vote, failure to address the issuer's response to that vote consistent with the 2012 updates may result in an against or withhold voting recommendation by ISS with respect to compensation committee members (or, in egregious cases, the entire board).

Key changes reflected in the 2012 updates are summarized below.

Pay-for-Performance

One of the most important changes in the updated ISS proxy guidelines is the change in the manner of analyzing pay-for-performance to provide a "more robust view of the relationship between executive pay and performance" from both a short-term and long-term perspective. The updated ISS policy, as reflected below, is more detailed in its analysis.

	2011 ISS pay-for-performance analysis	**2012 ISS pay-for-performance analysis**
Peer Group Alignment:	Total shareholder return (TSR) over a one- and three-year period compared to a company's peer group	The alignment of a company's TSR and the CEO's total pay with that of its peers over a one-year and three-year period
		CEO total pay as compared to the peer group median
CEO pay aligned with Total Shareholder Return:	The relationship between CEO pay and TSR over recent and long-term periods	• The degree of alignment between the trend in CEO pay and the trend in annualized TSR over a five year period.

Under the revised guidelines, ISS will identify a company's peer group as 14-24 companies selected based on market capitalization, revenue (or assets for financial firms) and Global Industry Classification Standard (GICS). In most, if not all, cases this group will be different than the peer group a company uses in its determination of executive compensation.

If ISS finds that pay and performance are "misaligned" based on the above new criteria, it will evaluate additional qualitative factors such as performance goals in relation to overall compensation, time-based versus performance equity awards, financial results of the company and any other relevant factors to determine whether the compensation practices support long-term value creation and are aligned with shareholder interests. Mitigating factors may be considered as well, such as the mix of performance- and non-performance-based pay, biennial grant practices, impact of a newly hired chief executive officer (CEO) and the rigor of performance programs.

The revised guidelines state that in general, a new CEO will not exempt the company from consideration under the analysis "as the compensation committee is also accountable when a company is compelled to significantly 'overpay' for new leadership due to prior poor performance."

While the new policy provides more detailed criteria for ISS's analysis, the new policy does little to provide predictability for companies in assessing where they will land on ISS's evaluation spectrum for pay-for-performance. ISS will continue to evaluate pay-for-performance on a case-by-case basis. ISS expects to provide additional guidance on is pay-for-performance methodology in December 2011.

Compensation Committee Members and 2012 Say-on-Pay Vote

ISS's 2012 Policy Survey indicates that shareholders expect explicit responses from companies describing measures to improve their pay practices where the prior year's say-on-pay proposal failed to garner "meaningful support" (*i.e*. opposition vote greater than 30 percent). If a company's 2011 say-on-pay proposal received less than 70 percent of the votes cast, ISS will recommend votes on a case-by-case basis for compensation committee members (and in extreme cases, for the full board) and management say-on-pay proposals.

ISS's recommendation will take into account a company's disclosure as to its response to the say-on-pay voting results, including substantive disclosure of company discussions with major institutional investors regarding the reasons behind the low levels of support and specific board actions taken to address the compensation practices that prompted the lack of support.

In the wake of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) and ever-increasing scrutiny on executive pay, ISS's updated policy is a reflection of the growing demand for engagement by companies with their shareholders regarding compensation practices and policies. It is important to remember that this change in ISS policy is occurring at the same time as SEC proxy rules require issuers to disclose the extent to which the compensation committee has taken into account the say-on-pay voting results from the 2011 proxy season. It is prudent for issuers with relatively low levels of support from shareholders to take special care in disclosing the compensation committee's response to the 2011 "say-on-pay" vote, particularly with respect to outreach efforts with investors. Issuers may also want to consider if any additional action by the compensation committee is appropriate prior to its 2012 proxy filing.

Company Response to Frequency of Say-on-Pay Votes

U.S. Securities and Exchange Commission (SEC) rules require companies to provide shareholders the opportunity to vote on the frequency with which advisory say-on-pay votes will be held. ISS will recommend voting against any incumbent director on a board that implemented a say-on-pay vote less frequently than the frequency which received the greatest number shareholder votes.

Proxy Access

Earlier this year, the SEC lifted its stay on its 2010 amendments to Securities Exchange Act Rule 14a-8, restricting the exclusion of proxy access bylaw proposals in proxy statements in 2012. Because the debate on proxy access is still fluid, ISS's policy is intended to provide ISS with flexibility on proxy access proposal recommendations and does not provide guidance on specific elements of proposals that it would support. ISS will continue to recommend votes on these proposals on a case-by-case basis, but will focus on specific factors in its analysis, such as the percentage and duration thresholds for stock ownership, the maximum proportion of directors that shareholders may nominate each year and the method of determining which nominations will be included on the ballot if multiple shareholders submit nominations. ISS expects to issue additional guidance in January 2012 on this matter, based on its examination of the texts of specific proposals.

Risk Oversight for Directors

ISS notes that a number of failures in risk oversight by boards in recent years have given rise to greater emphasis on the board's risk oversight function, and points to recent well publicized corporate scandals as examples of such failures. As a result, ISS revised its list of failures that could lead to a recommendation to vote against an incumbent director in an uncontested election to explicitly include risk oversight.

ISS's criteria for determining whether a corporate disaster or scandal has a causal nexus to a board's oversight function is unclear. Nevertheless, companies should ensure that their board's risk oversight policies are up-to-date and clearly described in their public filings.

Social/Environmental Policy Updates

ISS also adopted or updated several social and environmental policies. These reflect the increased "traction" of shareholder initiatives seeking more transparency on corporate governance processes with respect to certain social and political issues. Among the new/updated policies are:

Political Spending– the updated ISS policy provides for a general recommendation to vote in favor of proposals that request disclosure of a company's political contributions and trade association spending policies and activities rather than recommending votes on a case-by-case basis as had been the previous ISS policy.

Lobbying Activities –the updated ISS policy recommends a vote in favor of proposals relating to any effort by a company to inform or sway public opinion as opposed to recommendations only for formal political lobbying activities as had been the previous ISS policy.

Hydraulic Fracturing – a new policy regarding the natural gas extraction technique, typically called fracking, to vote in favor of proposals that request greater disclosure of a company's fracking operations and measures taken to mitigate community and environmental risks. The recommendation will take into account several factors, including (i) the company's disclosure compared to its peers and (ii) controversies, fines or litigation related to its fracking operations.

Workplace Safety – a new policy recommendation to vote in favor of proposals requesting workplace safety reports, including reports on accident risk reduction efforts.

Water Issues – a new policy to recommend, on a case-by-case basis, voting on proposals that request a company establish a new policy regarding or provide a report on water-related risks and concerns.