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ISS ISSUES UPDATES TO PROXY VOTING POLICIES AND GOVERNANCE RISK INDICATORS

January 9, 2012

The proxy advisory firm Institutional Shareholder Services Inc. ("ISS") recently issued its 2012 proxy voting policy updates (the "Policy Updates"), as well as a new version of its Governance Risk Indicators (GRId) model ("GRId 2.0").[1] The Policy Updates, which apply to shareholder meetings on or after February 1, 2012, focus on pay-for-performance analysis and board response to say-on-pay votes. The GRId updates, effective February 24, 2012, include changes to content and methodology designed to better align GRId ratings with ISS proxy voting guidelines. Given ISS' influence in today's compensation and governance environment, many public companies will want to consider the Policy Updates and GRId 2.0 in evaluating whether aspects of their governance or compensation practices should be modified. Companies also should take care to ensure that favorable compensation and governance practices are disclosed – or questionable practices explained – in their public filings so that ISS will have the benefit of such information when evaluating a company's practices. The remainder of this client alert summarizes key aspects of both updates.

2012 Policy Updates

Executive Compensation

Methodology for Determining Pay-Performance Alignment

One of the key components of ISS' analysis in considering management say-on-pay proposals is the pay-for-performance evaluation. Currently, ISS considers whether a company's one-year and three-year total shareholder returns ("TSR") are in the bottom half of its four-digit Global Industry Classification Standard ("GICS") group and whether the total compensation of a CEO who has served at least two consecutive fiscal years is aligned with the company's TSR over time, including both recent and long-term periods. In an effort to provide clients with a more robust view of the relationship between executive pay and performance at portfolio companies, ISS has revised its analysis to consider the following factors with respect to companies in the Russell 3000 index:

- Peer group alignment:
  - The degree of alignment between the company's TSR rank and the CEO's total pay rank within a peer group, as measured over one-year and three-year periods (weighted 40%/60%); and

[1] The Policy Updates are available at http://www.issgovernance.com/policy/2012/policy_information, and the GRId 2.0 Technical Document and related FAQs are available at http://www.issgovernance.com/grid-info.

- The multiple of the CEO's total pay relative to the peer group median;[2] and

- Absolute alignment: The absolute alignment between the trend in CEO pay and company TSR over the prior five fiscal years – i.e., the difference between the trend in annual pay changes and the trend in annualized TSR during the period.

If such analysis demonstrates significant unsatisfactory long-term pay-for-performance alignment or, in the case of non-Russell 3000 index companies, misaligned pay and performance are otherwise suggested, ISS will consider the following qualitative 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, 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.

Board Response to High Levels of Say-On-Pay Opposition

Currently, ISS will vote against (or withhold votes from) compensation committee members in egregious situations, when no management say-on-pay vote is on the ballot or when the board has failed to respond to concerns raised in prior say-on-pay evaluations. Additionally, in voting case-by-case on management say-on-pay proposals, ISS will consider the board's responsiveness to investors' input and engagement on compensation issues, such as any failure to respond to majority-supported shareholder proposals on executive pay topics and any failure to respond to concerns raised in connection with significant opposition to the prior year's say-on-pay vote.

In response to the new proxy requirement for issuers to disclose whether and how their compensation policies and decisions have taken into account the results of the most recent say-on-pay vote, ISS has revised its analysis. Under the Policy Updates, ISS will vote case-by-case on compensation committee members (or, in exceptional cases, the full board) <u>and</u> the management say-on-pay proposal if the company's previous say-on-pay proposal received the support of less than 70% of votes cast, taking into account:

- The company's response, 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 the issues that contributed to the low level of support; 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.

[2] The peer group is generally comprised of 14-24 companies that are selected using market cap, revenue (or assets for financial firms), and GICS industry group, via 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.

Board Response to Frequency of Say-On-Pay Vote Results

Issuers are required, at least every six years, to provide shareholders with a non-binding advisory vote to select the preferred frequency of say-on-pay votes – every one year, two years or three years. Because this requirement was effective for the first time in 2011, ISS currently has no policy regarding board responses to such say-on-pay frequency votes.

Pursuant to the Policy Updates, ISS will now vote against (or withhold votes from) the entire board of directors (except new nominees, who should be considered case-by-case) if the board implements a say-on-pay vote on a less frequent basis than the frequency that received the majority of votes cast in the most recent say-on-pay frequency vote. In addition, ISS will vote case-by-case on the entire board if the board implements a say-on-pay vote on a less frequent basis than the frequency that received a plurality, but not a majority, of the votes cast in the most recent say-on-pay frequency vote, taking into account:

- The board's rationale for selecting a different frequency from the frequency that received 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 previous year's support level on the company's say-on-pay proposal.

Incentive Bonus Plans and Tax Deductibility Proposals

ISS has revised its policy regarding proposals for shareholder approval of executive incentive bonus plans to address the treatment of such proposals by recent IPO companies. Under the Policy Updates, ISS will generally vote for a proposal to approve or amend an executive incentive bonus plan 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) of the Internal Revenue Code of 1986, as amended ("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.

ISS will vote against such proposals if the compensation committee does not fully consist of independent directors, per ISS' director classification, or if the plan contains excessive problematic provisions.

ISS will vote case-by-case on such proposals 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); or
- The company is presenting the plan to shareholders for Section 162(m) favorable tax treatment for the first time after the company's IPO, 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 (other factors such as pay-for-performance or problematic pay practices as related to say-on-pay may be considered if appropriate).

Corporate Governance

Proxy Access

Under its current policy, ISS will vote case-by-case on shareholder proposals asking for open or proxy access, taking into account the ownership threshold proposed in the resolution and the proponent's rational for the proposal at the targeted company in terms of board and director conduct. Under the Policy Updates, ISS will continue to vote case-by-case on such proposals, but the factors to be considered will now include:

- Company-specific factors; and
- Proposal-specific factors, including:
  - 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.

Voting on Director Nominees in Uncontested Elections

ISS considers four fundamental principles when determining votes on director nominees: board accountability, board responsiveness, director independence and director competence. Within the board accountability analysis, ISS will vote against (or withhold votes from) directors due to certain enumerated governance failures. The list of governance failures has been revised in the Policy Updates to now include an explicit reference to risk oversight, so that the policy now states that ISS will vote against (or withhold votes from) individual directors, members of a committee or the entire board, due to:

- 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.

GRId 2.0

ISS launched GRId two years ago as a new measure of governance-related risk, focusing on four areas: audit, board, shareholder rights and compensation. GRId was designed to provide institutional investors with an understanding of high-level areas of concern across a portfolio, together with analytical tools to help them dive deeply into governance at individual companies, and to provide companies with a basis for aligning their corporate governance structure and practices with shareholder interests. ISS is now launching GRId 2.0 in 2012 in response to investors' desire for greater alignment of the GRId ratings with ISS vote recommendations and for more information in connection with the ratings. The updates to GRId consist of changes to content and ratings methodology.

Content Updates

According to ISS, the content in GRId 2.0 will provide more and better insight into governance issues. More than 30 questions have been added or revised, including questions incorporating ISS' new pay-for-performance quantitative methodology and executive compensation data (e.g., say on pay, equity plans, severance pay and perquisites), additional information on related-party transactions and board relationships, as well as a more comprehensive evaluation of takeover defenses. Questions and answers have been reformulated to provide a clearer sense of underlying data. Finally, subcategories have been reorganized into a more logical analytical framework.

Ratings Methodology Updates

The GRId ratings methodology has been revised in GRId 2.0 to provide more reliable and more transparent flags of governance-related risk, together with better alignment of GRId ratings to the analytical approach of ISS proxy research. ISS has refined the scoring mechanism in order to ensure that the risks connected with individual governance practices are properly reflected in the high-level scores and concerns. In addition, GRId 2.0 will provide category-level ratings, in order to better communicate the degree of concern for each company.

Conclusion; Contact Information

If you have any questions regarding the Policy Updates or GRId 2.0, please contact Meredith Burbank (http://www.wcsr.com/MeredithBurbank), the principal drafter of this client alert, or you may contact the Womble Carlyle attorney with whom you usually work or one of our Corporate and Securities attorneys at the following link: http://www.wcsr.com/profSearch?team=corporateandsecurities.