Client Alert.

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ISS Releases U.S. Proxy Voting Guidelines for 2012

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On November 17, 2011, Institutional Shareholder Services ("ISS"), the leading proxy advisory firm, released 2012 updates to its U.S. proxy voting guidelines.[1] The policy updates include revisions to ISS's pay-for-performance policy and methodology. Other significant updates relate to the responsiveness of boards of directors to prior shareholder advisory votes on executive compensation, or "say-on-pay" votes, and the frequency of such votes, as well as revisions to the policy on proxy access in the wake of revisions to the Securities and Exchange Commission's ("SEC") shareholder proposal rules. The ISS policy changes will be effective for shareholder meetings on or after February 1, 2012.

PAY-FOR-PERFORMANCE

As part of its evaluation of a company's say-on-pay proposal, ISS conducts a pay-for-performance evaluation that considers the alignment of the CEO's pay with company performance over time. ISS has revised its approach to pay-for-performance in response to comments from both investors and issuers that pay-for-performance should be viewed in a long-term context rather than focusing only on the most recent year. As a result, ISS has made some changes to its pay-for-performance analysis to consider pay and performance over a longer time frame.

The new approach to pay-for-performance begins with a quantitative analysis for companies in the Russell 3000 index. The quantitative analysis considers both peer group alignment and absolute alignment. ISS generally establishes a peer group of 14 - 24 companies based on market capitalization, revenue and industry group.

The peer group alignment has two components. The first is the degree of alignment between the company's total shareholder return rank within the peer group and the CEO's total pay rank within the peer group. This alignment is measured over both a one-year and a three-year period, with the periods weighted 40% and 60%, respectively. The second component is the multiple of the CEO's total pay relative to the median CEO pay in the peer group.

The absolute alignment portion of the quantitative analysis looks at the alignment between the trend in CEO pay and company total shareholder return over the prior five fiscal years. ISS indicates that this is the difference between the trend in annual changes to compensation and the trend in annual total stockholder return over the five-year period.

For companies in the Russell 3000 index, if the quantitative analysis does not demonstrate unsatisfactory pay-for-performance alignment, ISS would not conduct a further qualitative analysis. For non-Russell 3000 index companies where a pay-for-performance misalignment is otherwise suggested, and for companies for which the quantitative analysis demonstrates unsatisfactory pay-for-performance alignment, ISS will analyze the following qualitative factors:

- The ratio of performance- to time-based equity awards;
- The ratio of performance-based compensation to overall compensation;

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[1] The ISS 2012 Updates are available at http://www.issgovernance.com/policy/2012/policy_information.

- The completeness of disclosure and rigor of performance goals;
- The company's peer group benchmarking practices;
- Actual results of certain financial and operational metrics;
- Special circumstances (*e.g.*, new CEO); and
- Any other relevant factors.

ISS indicates that its revised approach will better address market needs and identify pay-for-performance alignment over a longer period of time, which will give institutional investors a better view of the relationship between executive pay and company performance over time.

RESPONSE TO SAY-ON-PAY VOTE

For most U.S. public companies, the 2011 proxy season was the first year the company conducted a say-on-pay vote mandated by Section 951 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). As part of the rules implementing Section 951 of the Dodd-Frank Act, the SEC requires an issuer to discuss in its Compensation Discussion and Analysis ("CD&A") whether, and if so, how, the issuer considered the results of the most recent say-on-pay vote in determining compensation policies and decisions.

Even though any issuer that conducted a say-on-pay vote in 2011 will be required to discuss the results in its 2012 CD&A, ISS has indicated that it will focus on issuers whose prior-year say-on-pay votes received the support of less than 70% of the votes cast. ISS will recommend voting, on a case-by-case basis, against members of the compensation committee (or, in exceptional cases, the full board) if the prior-year say-on-pay vote received the support of less than 70% of the votes cast, but will take into account the company's response, including the disclosure of its efforts to engage with institutional investors and the specific actions it has taken to address the issues that contributed to the low level of support. In formulating its recommendation, ISS will also consider whether the issues are recurring or isolated, the company's ownership structure and whether the support for the say-on-pay vote was less than 50%.

As we enter the 2012 proxy season, we recommend that any company that received less than a very high level of support for its 2011 say-on-pay proposal should describe in detail its efforts to engage with its major shareholders and discuss the relevant changes to its compensation policies in light of the say-on-pay vote results. Companies who experienced support for its say-on-pay at levels less than 70%, however, should formulate their CD&A discussions with particular care given this new policy from ISS.

RESPONSE TO THE VOTE ON SAY-ON-PAY FREQUENCY

Another aspect of Section 951 of the Dodd-Frank Act was that shareholders must also vote, on a non-binding basis, on the frequency of say-on-pay votes. Shareholders are given the choice of having say-on-pay votes every year, every two years or every three years.

As part of its 2012 policy update, ISS indicates that it will recommend voting against or withholding votes from the entire board (other than new nominees) if the board implements a say-on-pay vote on a less frequent basis than the frequency that received a majority of the votes cast in the most recent frequency vote. For example, if a majority of the votes cast favor a frequency of every year for say-on-pay votes, and the board of directors instead opts to conduct say-on-pay votes every three years, ISS would recommend voting against or withholding votes from each director in the upcoming proxy season.

ISS indicates that in cases where no one choice of frequency receives the support of a majority of the votes cast, the preferences of shareholders may be unclear. In these circumstances, ISS will consider its recommendation on a case-by-case basis, taking into account the board of director's rationale for its frequency decision, ownership structures, compensation concerns, and the level of support for say-on-pay.

PROXY ACCESS PROPOSALS

As we have discussed previously, amendments to the SEC's shareholder proposal rule, Rule 14a-8, recently went into effect following the vacating of Rule 14a-11 by the United States Court of Appeals for the District of Columbia Circuit.[2] These amendments to the SEC's existing shareholder proposal rule permit a "private ordering" approach to proxy access that was adopted at the same time as the mandatory proxy access rule, Rule 14a-11, which was subsequently vacated.

ISS indicates that several investors have indicated they plan to submit proxy access shareholder proposals in the coming proxy season. In addition, there is also the potential for a number of management proposals on proxy access given these changes to the shareholder proposal rule.

While the ISS policy on proxy access proposals remains a case-by-case approach, ISS indicates that it is expanding the factors that it will examine in formulating a recommendation on both shareholder and management proxy access proposals. These factors include the ownership threshold, both the percentage of ownership and the duration of ownership, the maximum proportion of directors that shareholders may nominate in a year, and the method for determining which nominations should appear on the ballot if there are multiple shareholder nominations.

OTHER POLICY CHANGES

In addition, ISS has changed its approach to recommendations on proposals to approve compensation plans for newly public companies that will entail a full equity plan evaluation when a company presents an equity plan proposal to comply with the provisions of Section 162(m) of the Internal Revenue Code. Under its prior approach, ISS typically recommended voting in favor of plan amendments to comply with Section 162(m).

ISS has also updated its policies to take a case-by-case approach to exclusive venue management proposals and to consolidate the factors it will consider on proposals on dual-class common stock structures. The 2012 policy update also changes the approach to proposals requiring corporate political contribution disclosure from case-by-case consideration to generally recommending voting in favor of such proposals. Finally, ISS has amended its policies on certain social and environmental issues, including hydraulic fracturing, recycling, lobbying issues, workplace safety and water issues.

[2] *See our September 7, 2011 client alert, SEC Will Not Appeal Proxy Access Decision; Shareholder Proposal Amendments Will Take Effect*, available at http://www.mofo.com/files/Uploads/Images/110907-SEC-Will-Not-Appeal-Proxy-Access-Decision.pdf.

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