

PROXY UPDATE

November, 2011

2012 ISS Proxy Policy Update

Institutional Shareholder Services (“ISS”) recently published updated policies for the 2012 proxy season (viewable [here](#)), which will become effective for meetings held on or after February 1, 2012.

The final policy changes do not differ significantly from the draft released in October, which we summarized in an earlier Proxy Update (viewable [here](#)).

The summary below highlights key changes to the ISS policies for 2012.

Key Changes

- **[New Methodology for Evaluating Pay-for-Performance:](#)** The most sweeping change in policy relates to how ISS will evaluate pay-for-performance and the impact this will have on Say on Pay and compensation proposals. This new methodology is far more opaque than it is currently, making it challenging to determine the results of ISS’ analyses in advance. While the new methodology allows ISS to make a recommendation *against* companies that have outperformed their index or peer group, it also grants ISS the flexibility to recommend *for* companies that have underperformed their peers on a TSR basis but have performed well operationally.
- **[30% Against on Say on Pay is the Line in the Sand:](#)** When Say on Pay (“SoP”) proposals received less than 70% support in the previous year, ISS expects an explicit response from the Board disclosing the actions taken to improve its pay practices, including engagement with institutional investors. ISS expects “substantive and meaningful disclosure”.
- **[Say on Frequency:](#)** 2011 was the first year of mandated Say on Frequency proposals and ISS has instituted a new policy for 2012 to vote against/withhold on the entire board of directors should the board opt to put executive compensation to a vote on a less frequent basis than shareholders approved. The new policy also contemplates recommending against/withholding on directors on a case-by-case basis should no frequency option receive a majority vote and the board implements a vote on executive compensation less frequently than the frequency which received a plurality of the vote.
- **[Proxy Access:](#)** ISS is “refining” the factors it will use to determine how to recommend on proxy access proposals. It will continue to rule case-by-case on these proposals. However, based on its comment letter to the SEC in support of proxy access, as well as its recommendations on similar proposals a few years ago, it seems clear that ISS will support most proxy access proposals. Indeed, ISS notes that it supports proxy access as “an important shareholder right”, and that proxy access is “complementary to other best-practice corporate governance features”.

- **Exclusive Venue Proposals:** 2011 saw a new management proposal relating to exclusive venue for shareholder dispute resolution at a number of companies. ISS did not have a policy for this proposal at the start of 2011 but adopted one mid-year. Its new policy will be case-by-case taking into account a number of factors, including whether the company has been “materially harmed by shareholder litigation”.
- **Political Contribution Proposals:** With the backdrop of a presidential election in 2012, we expect political contribution proposals to remain a hot topic. ISS has changed their policy from case-by-case and has moved to “generally recommend for” such proposals and has included, as a specific point of consideration in making its recommendation, the issuer’s disclosure of its oversight mechanisms relating to political contributions.
- **Lobbying Activities:** Due to an increase in shareholder proposals related to companies’ lobbying activities, ISS updated its guidelines on this issue to clarify a number of items, including that its guidelines extend beyond direct lobbying to broader efforts to sway public opinion.
- **ESG Issues:** ISS also added or updated policies for a number of environmental/social issues including hydraulic fracturing, recycling, water issues, and workplace safety.

Below is a more detailed discussion of the policy updates.

Evaluating Pay-for-Performance

The most significant change to its policy relates to ISS’ evaluation of pay-for-performance alignment. ISS indicates that its latest policy survey identified two factors as being highly relevant in evaluating pay-for-performance: pay relative to a company’s peers and pay that is disproportionate to the company’s performance trend. ISS will now focus on CEO pay over a longer term, rather than just the most recent year.

New Peer Group: As part of its new evaluation, ISS will no longer use a 4-digit GICS peer group, replacing it with a new, smaller, and what it believes will be a more suitable, peer group. The new peer group is generally comprised of 14-24 companies that are selected on the basis of market cap, revenue (or assets for financial firms), and GICS industry group, via a process that ISS says is “designed to select peers that are closest to the subject company in terms of revenue/assets and industry and also within a market cap range that is reflective of the company's life cycle maturity phase.”

ISS plans to disclose further information about its new peer group methodology in various communications leading up to the 2012 proxy season. However, ISS does not indicate whether it will reveal the names of the peer

group companies prior to the Proxy Season. We do believe, however, the companies of the ISS assigned peer group will appear on the actual voting recommendation report for the shareholders meeting.

Quantitative Analysis: By utilizing the quantitative analysis described below as an initial screen, ISS will seek to identify companies with strong, satisfactory and weak pay-for-performance alignment over the long term. ISS will consider the following:

- The degree of alignment between Total Shareholder Return (“TSR”) rank and CEO pay rank within the new peer group, over 1-year and 3-year periods, based on a 40/60 weighting.
- CEO pay relative to a peer median, which will be based on the same peer group. ISS believes this test will help identify high-performing companies that still are overpaying their CEOs.
- The absolute alignment of CEO pay to Total Shareholder Return over the previous 5 years.

Qualitative Analysis: From the quantitative analysis, if a company demonstrates “significant unsatisfactory long-term pay-for-performance alignment” ISS will then analyze a number of qualitative factors noted below. ISS does not define “significant unsatisfactory long-term pay-for-performance alignment” but clearly companies deemed to have weak alignment will receive further scrutiny under the qualitative section of the ISS test.

- ratio of performance-based equity awards to time-based equity awards,
- ratio of performance-based compensation to overall compensation,
- completeness of disclosure and rigors of performance goals,
- peer group benchmarking practices,
- actual results of financial metrics, both absolute and relative,
- special circumstances (e.g., a new CEO hired during the prior fiscal year), and
- “any other factors deemed relevant” (this will allow ISS considerable latitude).

In its draft policy, ISS indicated that it back-tested this methodology and did not expect a significant change in the number of SoP against recommendations year-over-year; however, the companies identified for against recommendations may differ from last year and, as a result, some issuers may be surprised.

We continue to believe (and this new policy reinforces that belief) that board decisions and solicitation strategies must not hinge on the latest ISS methodologies. Rather, boards should make decisions that take into account the perspectives of their actual shareholders, and pay-for-performance rationales must be effectively articulated in the proxy statement. Each board should remain focused on the factors that drive long-term performance for their specific company and industry. Moreover, management should engage in direct dialogue with investors – to ensure that the information is understood and that relevant disclosure is presented as clearly as possible.

Board Response to Previous Year's Say on Pay Vote

ISS has leveraged the mandated Dodd-Frank disclosure relating to how or if the previous SoP vote impacted the Companies compensation decisions in one of its new guidelines. ISS has defined “significant opposition” to a SoP vote to be 30% of the shares voting. If the previous year's SoP vote received support from less than 70% of the shares voting, ISS expects an explicit response from the board regarding the company's pay practices.

In making its case-by-case vote recommendation on whether to withhold on compensation committee members (or, in exceptional cases, the whole board) and the SoP proposal for companies whose previous SoP proposal received support of less than 70%, ISS will take into account the following:

- The company's response, including:
 - Disclosure of engagement with institutional investors to determine the issues that contributed to the low level of support
 - Specific actions taken to address those issues
 - Other recent compensation actions taken by the company
- Whether the issues raised are recurring or temporary
- The company's ownership structure
- Whether the support level of the proposal was less than 50% which would warrant the highest degree of responsiveness

ISS notes that shareholders (and, by extension, ISS) will seek “substantive and meaningful disclosure” in determining whether the company has taken sufficient action to address the previous years against vote. ISS warned companies against the use of boilerplate language and urged companies to discuss any concrete actions taken by the board in response to the high level of dissention on the proposal. It also notes that this information should be readily identifiable in the proxy statement.

The scope of the response to this year's Say on Pay vote in the 2012 CD&A will depend largely on the vote the proposal received at the last annual meeting.

All companies should disclose the nature and extent of the engagement they had with their investors; this will be particularly important for companies that got less than overwhelming support for the SOP proposal. In addition, issuers will need to disclose what actions they have taken, if any, on their compensation practices based on investor feedback and the Board's review of their current practices. If no actions were taken, there needs to be clear and compelling disclosure of why the Board feels its compensation practices are in the best interests of the company.

The significant challenges that companies will face are 1) getting specific feedback from investors on their compensation practices, and 2) stressing the long-term nature of the changes made. This last point is particularly important since by the time the engagement process is completed after the vote, the next compensation cycle will already be under way. Clear disclosure that changes made are prospective, and may not impact the disclosure in the 2012 proxy, is important to get investors to focus on the long-term, rather than a one-shot look at practices that may be in the process of changing.

Board Response to the Say-on-Frequency Vote

Consistent with its board responsiveness policies, ISS will be policing whether boards followed the will of the shareholders concerning the frequency of future SoP votes. If one option received a majority vote and the Board opts to hold the executive compensation vote less often, ISS will recommend against the directors up for election.

In the case where no option received a majority of the vote, if the Board opts to vote on executive compensation on a less frequent basis than the choice that received a plurality of the votes, ISS will take into account the following factors in making its decision:

- The board's rationale for selecting that frequency,
- The company's ownership structure,
- ISS' analysis of whether there are compensation concerns or a history of problematic compensation practices; and
- The previous year's support level on the say-on-pay proposal.

ISS noted in its draft policy that only a small number of companies have decided to go with a less frequent vote on executive compensation than that chosen by shareholders, so this policy will only apply to a limited number of companies.

Proxy Access

According to ISS, due to the absence of a uniform standard, proxy access proposals could vary widely. As a result, ISS states that it needs to leave its decision making process open, thus giving itself wide latitude to potentially support various iterations of an access proposal.

We believe it is relevant to note that in a previous comment letter to the SEC in support of Proxy Access, ISS supported a Proxy Access right for 1% shareholders (regardless of an issuer's market capitalization) who had held stock for one year, but also indicated that two years was a reasonable period. Based on this perspective and its historical advocacy for shareholder empowerment, we expect ISS to support Proxy Access shareholder proposals

that are less restrictive than the 3% for three years which had been proposed by the SEC. The recently released United States Proxy Exchange (“USPX”) model proposal (click [here](#) to be directed to the model letter), which as part of its criteria states that a proponent must hold 1% for 2 years, may provide some guidance on current views of “best practices” on the issue.

In making its recommendation, ISS will take into account several factors, including:

- Company specific factors
- Proposed ownership thresholds,
- Maximum number of directors that may be nominated, and
- Method of determining which nominees should appear on the ballot if multiple shareholders submit nominations.

Demonstrating its support for a proxy access right, ISS has taken the proponent’s rationale for submitting the proposal out of its core factors in determining its vote recommendation, but notes that it will remain one of the numerous “other factors” it will consider.

In a companion Executive Summary piece (click [here](#) for a copy), ISS notes that in January of 2012 it expects to start providing additional guidance on this issue through FAQs based on specific proposal texts.

At this point it is too early to know what ISS and the larger institutional community will accept as a standard for Proxy Access. We expect ISS and many institutional shareholders will support access proposals that are more lenient than the proposed SEC model, while some institutional shareholders will vote on a case-by-case basis by determining the need for an access right at individual companies based on the company’s performance and other governance issues. While the shareholder profile will play a significant role in the voting outcome, the companies most at risk of having these proposals pass will be those with sustained poor performance and/or sustained governance issues. We expect these will be the companies most often targeted during the 2012 proxy season, virtually guaranteeing a high average vote.

As of this memo, Ken Steiner, an individual investor and member of the USPX, has already submitted two shareholder proposals based on the model proposal put forth by the USPX.

Election of Directors – Risk Oversight

ISS has added risk oversight to the criteria that it will use to evaluate the election of directors and to determine whether to recommend a withhold vote on individual directors or the entire board in extraordinary circumstances.

ISS notes that over the last few years there has been a multitude of well-publicized failures of risk oversight by boards. These failures are not just limited to financial institutions as part of the financial crisis; they extend to other events such as the Deepwater Horizon oil spill or the scandals surrounding News Corporation's U.K. operations this past year.

ISS does not intend this policy to keep boards from taking prudent business risks, but it is intended to address situations where it believes that there has been a material failure in the board's role in the oversight of the company's risk management practices.

We expect this policy will only affect a small number of companies who are believed to have encountered egregious risk management failures.

Exclusive Venue Proposals

This was a new management proposal during the 2011 proxy season that asked shareholders to approve any action brought by a shareholder be adjudicated in a specific court. Thus far, all of the proposals have sought Delaware as the exclusive venue. Issuers began to seek shareholder approval of exclusive venue charter provisions after a court opinion suggested that simple board adoption of such a bylaw provision might not be enforceable.

ISS' new policy will review these proposals on a case-by case basis taking into account the following:

- Whether the company has been materially harmed by shareholder litigation outside its jurisdiction of incorporation, based on disclosure in the company's proxy statement.

The policy will also look at whether the following "good governance" features are present:

- Annually Elected Board,
- A majority vote standard in uncontested elections,
- Absence of a poison pill, unless the pill was approved by shareholders.

Its previous policy had also included the meaningful ability (generally 10% demand level) of shareholders to call a special meeting as one of the items ISS would take into account; however, this was deleted under 2012 policy as not being relevant.

We have reviewed the proposals and ISS recommendations to date, and the 2012 ISS Policy Update does not contain the strong language of the individual analyses we reviewed during the 2011 proxy season. ISS may take a more lenient approach to the topic in 2012, but requests more disclosure in the proxy statement as a rationale for adoption of such a clause. While one of the many purposes behind these clauses is to serve as a deterrent for frivolous litigation, ISS requests disclosure of how a company has been or would be adversely affected by litigation outside the chosen state. Since this is a

relatively new issue, we plan on sending out another Proxy Update shortly which will discuss this issue in more detail. We are likely to see more of such proposals next season as more issuers discuss the litigation environment with counsel, especially with proxy access looming on the horizon.

Capital Structuring – Dual Class Structure

For issuers trying to get a new class of common stock approved, ISS has consolidated its policies and will now generally vote against these proposals unless:

- The company discloses a compelling rationale for the dual-class 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 will be transitory,
- The new class is intended for financing purposes with minimal or no dilution to current shareholders,
- The new class is not designed to preserve or increase the voting power of an insider or significant shareholder.

ISS indicates that most investors view a dual class structure as being negative because of the potential impact on their financial investment, as well as on shareholder rights. ISS believes this new policy is aligned better with the investor’s views and only in the most compelling cases, generally when a company is on the brink of dissolution, will ISS support a dual-class structure.

Social and Environmental Issues

ISS has modified some current policies, as well as added some new policies relating to environmental and social issues. We expect that disclosure of political contributions and lobbying proposals will be spotlight issues for 2012 with the Presidential election race heating up.

Political Contributions

ISS historically has evaluated these shareholder proposals on a case-by-case basis, however, under its new policy it will “Generally Vote For” these referendums. We do not view this change as material since ISS has supported the significant majority of these shareholder proposals over the past four years anyway. Of particular note, ISS modified its policy to consider the company’s political contribution oversight mechanisms as well as the substance of current disclosure and any recent controversies, fines or litigation relating to a company’s political contributions or activities in making its recommendation.

Lobbying Activities

ISS has adjusted its lobbying policy to clarify that it applies to proposals seeking information on a company’s lobbying activities and not just those seeking information on the company’s lobbying initiatives. ISS is also clarifying that the policy applies to proposals addressing broader efforts by the company to inform or sway public opinion in addition to more formalized lobbying efforts.

ISS notes that corporate grassroots lobbying efforts became a focus for shareholder proponents in 2011 and that is one reason for the change in policy.

The new policy reads:

Vote case-by-case on proposals requesting information on a company’s lobbying activities, including direct lobbying as well as grassroots lobbying activities, considering:

- The company’s current disclosure of relevant policies and oversight mechanisms,
- Recent significant controversies, fines or litigation related to the company’s public policy activities,
- The impact that the policy issues may have on the company’s business operations.

Hydraulic Fracturing

This proposal focuses on the natural gas extraction process, also known as fracking, in which water, sand, and chemicals are injected under high-pressure into gas-bearing shale. These proposals were first introduced in 2010 where support averaged approximately 30% of the votes cast. The average increased to 40% of the votes cast in 2011.

Since few companies currently meet the disclosure requirements outlined in the proposal, the proposed policy generally will cause ISS to support shareholder proposals asking for disclosure of the measures a company has taken to mitigate and manage potential environmental and community impact from fracking.

The ISS evaluation will consider various factors, including:

- current level of disclosure,
- disclosure relative to peers,
- relevant local, state, or national regulatory developments; and
- fines, controversies, or litigation related to the company's fracking.

Corporate Recycling

ISS will continue to review these proposals on a case-by-case basis but it has broadened the policy to include proposals that seek information on a company's existing recycling efforts and also to explicitly include a company's current level of disclosure regarding such programs when making its voting recommendation.

Workplace Safety

ISS sees this as an emerging issue in the wake of the Deepwater Horizon incident in the Gulf and other accidents at oil refineries recently. Four proposals came to a vote last year and ISS expects to see additional proposals in 2012. ISS will vote case-by-case on requests for reports for workplace safety taking into account:

- The current level of disclosure,
- The nature of the company's business, specifically regarding company and employee exposure to health and safety risks,
- Recent significant controversies, fines or violations related to workplace health and safety,
- The company's workplace health and safety performance relative to peers.

Water Issues

Previously, ISS had applied its general environmental policy to water-related proposals. ISS notes that water-related risk proposals are being submitted more frequently and ISS needs to codify the way it reviews these proposals into a specific policy.

ISS will vote case-by-case on proposals requesting a company report on or to adopt a new policy on water-related risks and concerns, taking into account:

- The company's current disclosure of relevant policies, initiatives, oversight mechanisms and water usage metrics,
- Whether or not the company's existing water-related policies and practices are consistent with relevant internationally recognized standards and national/local regulations,
- The potential financial impact or risk to the company associated with water-related concerns or issues,
- Recent, significant company controversies, fines or litigation regarding water use by the company and its suppliers.

As noted above, ISS has stated that it would be issuing further information regarding its pay-for-performance methodology; its process for determining peer groups used in the pay-for-performance analysis, and will also provide additional guidance with regard to Proxy Access proposals starting in January. We will continue to keep you apprised of these developments as this new information is made available.

In the meantime should you have any questions, please contact your Morrow representative or call us at (203) 658-9400.

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