

PROXY UPDATE

November, 2011

2012 ISS Draft Policies for Comment

Say on Pay (“SoP”) dominated the 2011 proxy season and is the focal point of the 2012 ISS Draft Policies for Comment. Not only has ISS outlined proposed guidelines to assess a Board’s response to the 2011 SoP proposal, but it also has detailed a revised framework to evaluate pay-for-performance. This new evaluation will be utilized when ISS reviews 2012 SoP proposals and may impact future assessments of director elections and equity compensation plans. The new methodology is more opaque than the prior approach, which will provide ISS greater discretion to oppose objectionable pay structures – even if a company has outperformed its index or peer group.

We have outlined below the proposed policy changes and have offered our thoughts on the ISS evaluation of SoP and other matters, including shareholder proposals on Proxy Access and political contributions.

Board Response to Prior Year SoP Vote

As part of Dodd-Frank, issuers are required to disclose in their 2012 CD&A’s “...*whether and, if so, how the registrant has considered the results of the most recent shareholder advisory vote on executive compensation.*”

Significant Opposition

Results of the ISS policy survey, which was conducted in advance of the draft policy release, revealed that a majority of investors (86%) and issuers (52%) believe an explicit response from the Board (regarding improvements to pay practices) should be required if a prior SoP proposal was opposed by at least 40% of the votes cast. 72% of investors and 40% of issuers felt an explicit response should be required if opposition exceeded 30% of the votes cast.

In its Draft Policies, ISS requests comment on whether opposition in excess of 30% of the votes cast is an appropriate level to expect an explicit response. We interpret this query to mean that at least 30% opposition will be considered significant by ISS and should compel an explicit response from an issuer. For companies with large insider ownership or dual class structures, the trigger for an explicit response may be lower; issuers with large affiliated blocks should calculate their SoP results excluding these blocks.

When assessing the appropriateness of a Board’s response, ISS will consider a number of factors; including “disclosure of outreach efforts to major institutional investors” and “concrete actions” the Board has taken or will take to address the underlying causes of the opposition. Not surprisingly, ISS will seek disclosure that is “comprehensive and meaningful.” Additionally, ISS will consider other recent actions taken by the Board and will re-evaluate current executive compensation practices to determine if problematic pay practices reflect one-time occurrences or recurring events.

If ISS believes a company is not sufficiently responsive to a prior year's vote, it will oppose the SoP proposal and may recommend withhold/against votes on Compensation Committee members or, in egregious situations, the entire Board.

By seeking disclosure on outreach efforts to institutional investors, ISS is strongly encouraging an annual engagement process between issuers and institutional investors. For many years, we have supported ongoing and consistent dialogue between companies and their major shareholders. In the case of SoP proposals, this engagement can provide clarity for both issuers and investors. Moreover, we believe the perspectives of shareholders are crucial to Compensation Committees making informed and thoughtful decisions and to management providing clear and effective disclosure.

Evaluation of Executive Pay (SoP)

As expected, ISS has developed an evaluation of pay-for-performance that provides wide latitude to assess executive compensation structures and valuations. This latest approach is highly unpredictable and re-enforces our opinion 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 actual shareholders, and pay-for-performance rationales must be effectively articulated in the proxy statement. Moreover, management should engage in direct dialogue with investors – to ensure that information is understood and that relevant disclosure is presented as clearly as possible. We do not suggest ignoring ISS. In fact, we believe understanding the practices and calculations that drive its pay-for-performance assessments are important; however, each board should stay focused on the factors that drive long-term performance for their specific company and industry.

ISS claims its new methodology will identify companies with long-term pay-for-performance misalignment, in contrast to its current approach that focuses on underperformance against a broad industry group and the CEO's compensation in the most recent fiscal year. The new methodology still will center on CEO compensation, but it will measure the appropriateness and efficacy of executive pay by incorporating additional quantitative metrics:

- ISS will consider the degree of alignment between Total Shareholder Return and CEO pay within a new peer group (that is smaller but more suitable than the four-digit GICS group that ISS currently uses), over 1-year and 3-year periods, based on a 40/60 weighting.
- ISS will evaluate CEO pay relative to a peer median, which will be based on the peer group. ISS believes this test will help identify high-performing companies that still are overpaying their CEOs.
- ISS will assess the absolute alignment of CEO pay to Total Shareholder Return over the previous 5 years.

New Peer Group: The Draft Policies indicate that ISS no longer will compare company performance to the company's GICS group. It will use a new peer group that will be: "...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 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." Based on discussions with ISS, we understand that ISS may provide issuers with the companies within the chosen peer group at some point prior to the proxy season, but at the very least the peer group will be identified in its report for the annual meeting.

From this quantitative review, ISS will characterize companies as demonstrating strong, satisfactory, or weak pay-for-performance alignment over an extended period. Companies with weak alignment will be subjected to further review prior to ISS determining a final vote recommendation. Companies receiving strong or satisfactory alignment generally will receive favorable vote recommendations on SoP proposals.

For companies demonstrating weak alignment, ISS also will consider numerous other factors in making their final vote recommendation, including:

- ratio of performance-based equity awards to time-based equity awards,
- ratio of performance-based compensation to non-performance-based compensation,
- robustness 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" (what we refer to as the "kitchen sink clause").

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

Board Response to Say on Frequency

ISS will be implementing a new policy to assess issuer responses to Say on Frequency proposals. This policy only applies to companies that adopt less frequent SoP votes than the alternatives supported by shareholders. The proposed policy has two parts:

- 1) If a Board implements a less frequent SoP vote than what was approved by a majority of the votes cast, ISS will recommend against/withhold votes on all continuing directors.
- 2) If a Board implements a less frequent SoP vote than what was approved by a plurality of the votes cast (but not a majority of the votes cast), ISS will recommend against/withhold votes on a case-by-case basis. ISS

will take into account the Board's rationale for choosing the frequency, the company's ownership structure, any history of problematic pay practices, existing compensation concerns, and the level of support for the previous year's SoP proposal.

ISS indicates that less than 1% of companies have chosen to implement a frequency that differs from the preferred alternative of shareholders, so this policy only will impact a small number of issuers; however, we believe ISS will oppose director nominees in the vast majority of these situations.

Proxy Access Shareholder Proposals

ISS is proposing an enhanced policy on Proxy Access shareholder proposals. ISS will take into account several factors, including:

- proponent's rationale for targeting the company,
- 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.

ISS points out that these assessments are among the most important factors that will be considered, but other criteria also may be incorporated.

In a comment letter to the SEC, ISS supported Proxy Access for 1% shareholders (regardless of an issuer's market capitalization) who had held stock for one year, but 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 that had been proposed by the SEC.

Environmental and Social Shareholder Proposals

Political Contributions

With a presidential campaign in full swing by next year's proxy season, we expect Political Contribution shareholder proposals to receive increased scrutiny in 2012. ISS historically has evaluated these shareholder proposals on a case-by-case basis but is considering a new policy to "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. As part of its updated assessment of political contribution disclosure, ISS will review 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.

Hydraulic Fracturing

ISS is proposing a new policy to assess Hydraulic Fracturing, also known as fracking, shareholder proposals. This proposal focuses on the natural gas extraction process in which water, sand, and chemicals are injected under high-pressure into gas-bearing shale. These proposals were introduced in 2010; support averaged 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.

The impact of the new policy is negligible, since it merely codifies a practice that ISS already has had in place. In fact, ISS supported all eleven Hydraulic Fracturing shareholder proposals that appeared in 2011 proxy statements.

ISS is expected to release its final policies during the week of November 14. We will keep you updated of any material changes from the draft policies. In the meantime, please feel free to contact your Morrow representative should you have any questions.

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