



## ISS' Annual Policy Review - And What You Should Do

In this Alert, we describe ISS' 2011-2012 policy review process, where we now are in this process (the comment period closes October 31 – get your comments in now), and what companies should be doing even before ISS' policy changes are finalized and released in mid-November.

Each year, commencing soon after the spring proxy season, ISS initiates an annual review of its policies which culminates in the November release of new or revised policies and evaluative considerations they will employ the following year. In part due to long-standing criticism from issuers and their advisors, as well as the more recent scrutiny they are under as part of the SEC's "Proxy Plumbing" review, ISS increasingly has made this process more inclusive and transparent, including by seeking input from a larger number of issuers.

### 1: ISS' 2011-2012 Policy Survey

As part of this process, during this past summer ISS surveyed institutional investors and issuers in the US as well as other markets about potential topics warranting policy changes. The survey received responses from 138 institutional investors (63% of these US-based) and 197 corporate issuers (81% of these US-based). As a measure of size (particularly important on the investor side, as assets under management will in many cases correlate with larger equity voting stakes at individual companies), almost 2/3 of the investor respondents had over \$10 billion in assets under management. Approximately 1/3 of issuer respondents had a market cap above \$10 billion.

### 2: The Survey Summary of Results

#### Top Areas of Focus – No Major Surprises

With some variations in relative ranking between investors and issuers, the survey reveals that the top areas of focus in the US (selected from among the available survey choices) are:

1. Executive compensation (top choice of investors as well as issuers)
2. Risk oversight (# 4 for investors; # 2 for issuers)
3. Board independence (# 2 for investors; # 4 for issuers)
4. Board competence (# 5 for investors; # 3 for issuers)
5. Shareholder rights - including anti-takeover defenses (# 3 for investors; # 5 for issuers)
6. Environmental/social shareholder proposals (# 6 for investors; # 7 for issuers)

The complete "2011-2012 Policy Survey Summary of Results" can be found here:

<http://www.issgovernance.com/files/PolicySurveyResults2011.pdf>

### 3: ISS Comment Period for 2012 Policy Changes – October 18 Through October 31

#### Which ISS Policies are most likely to Change for 2012?

Drawing directly on the above policy survey results, ISS has now disclosed the following seven US topics and related policies for which they are seeking comment:

1. Board Response to Management Say-on-Pay Vote
2. Board Response to Management Say-on-Pay Frequency Vote
3. Proxy Access Proposals
4. Evaluation of Executive Pay (Management Say-on-Pay) (also possibly for Canada)
5. Equity Plans Related to Section 162(m)
6. Hydraulic Fracturing Proposals
7. Political Contribution Proposals

For most of these areas, ISS indicated they do not anticipate the proposed changes to result in significantly more negative recommendations than under their existing policies. However, the final impact may differ from company to company.

Below, we summarize the proposed policy change for which comment is requested. To view the full description of the proposed changes, as well as to submit comments, go here:

<http://www.issgovernance.com/policy/2012comment>

#### Board Response to Management Say-on-Pay Vote (“MSOP”)

Phoenix Advisory Partners (“Phoenix”) believes that a big issue for 2012 will be enhanced investor scrutiny of companies receiving less-than-stellar 2011 Say on Pay votes, and that this has the potential to spill over into more critical voting on director elections as well. We believe that 2012 will not just be about the 40 companies that failed to gain majority support, but may also be about the roughly 400 companies that received less than 80% support.

According to the results of ISS’ 2011-12 policy survey, 100 percent of investor and issuer respondents believe that there should be an explicit response from the board regarding improvements to pay practices if an MSOP proposal receives more than 50 percent opposition. While there is more divergence of opinion with respect to lower opposition levels, on a cumulative basis 86 percent of investors (and 52 percent of issuers) believe an explicit response is warranted if the MSOP receives more than 40 percent opposition, and 72 percent of investors (versus 40 percent of issuers) believe that opposition in excess of 30 percent requires an explicit response.

For many investors, at least, it would indeed appear that “70 (percent) is the new 50 (percent)”.

#### Key Changes under Consideration

This policy update clarifies that ISS will recommend CASE-BY-CASE on Compensation Committee members (or in rare cases where the full board is deemed responsible, all directors) and the current MSOP proposal if the company’s prior say-on-pay proposal received significant opposition from votes cast.

Request for Comment – What represents “significant” opposition?

- Does a support level of less than 70 percent at the most recent vote warrant an explicit response from a company to address concerns – i.e., including actions or an action plan? If not, what opposition level warrants an explicit response?
- Should accountability be based on the results of more than one low MSOP vote?

## Board Response to Management Say-on-Pay Frequency Vote

### Key Changes under Consideration

ISS is proposing the following new policy/vote recommendation with respect to MSOP frequency:

1. Vote WITHHOLD/AGAINST on all incumbent director nominees if the board implements an advisory vote on executive compensation on a less frequent basis than the frequency which received the majority of votes cast at the most recent shareholder meeting at which shareholders voted on the say-on-pay frequency.
2. Vote CASE-BY-CASE if the board implements an advisory vote on executive compensation on a less frequent basis than the frequency which received a plurality, but not majority, of votes cast at the most recent shareholder meeting at which shareholders voted on the say-on-pay frequency.

### Proxy Access Proposals

#### Key Changes under Consideration

ISS' current policy on shareholder proposals asking for open or proxy access is to recommend on a CASE-BY-CASE basis taking into account:

- The ownership threshold proposed in the resolution; and
- The proponent's rationale for the proposal at the targeted company in terms of board and director conduct.

Under the proposed policy for 2012, ISS would continue to evaluate these proposals on a CASE-BY-CASE basis, also taking into account:

- The maximum number 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.
- With respect to "ownership threshold," ISS clarified that they will consider percentage AND duration of such ownership.

Regarding proxy access, the most frequent questions our clients are asking Phoenix include:

1. Which investors may seek to employ it?
2. What will be investors' target selection criteria?
3. What structures will investors propose (i.e. ownership thresholds and holding periods)?
4. Which of these will be acceptable/unacceptable to mainstream investors whose support will be critical to the success of these efforts?

### Evaluation of Executive Pay (Management Say-on-Pay)\*

#### Key Changes under Consideration

ISS currently identifies pay-for-performance disconnects by scrutinizing underperforming companies (i.e., those with 1- and 3-year total shareholder returns (TSRs) below the median of their 4-digit GICS industry group), and then applying a qualitative examination of other factors, including the year-over-year change in the CEO's total pay and a view of the five-year trends in company TSR and CEO pay, to determine whether pay and performance are misaligned.

Beginning in 2012, ISS proposes to use a new methodology to evaluate pay-for-performance alignment, which will identify companies that have demonstrated strong, satisfactory, or weak alignment between TSR and CEO pay over an extended period (i.e. over one, three and five years). We take this to mean that their initial screen will now incorporate a five year horizon.

*\*Note that the newly proposed pay-for-performance methodology is also being considered for Canada.*

## **Equity Plans Related to Section 162(m)**

### **Key Changes under Consideration**

Under a proposed IRS ruling related to Section 162(m), it is anticipated that there will be an increase in 162(m) proposals from recent IPO's seeking to ensure that certain awards qualify as "performance-based." Here, ISS is proposing to weigh the benefits to the company (and thus its shareholders) of tax deductibility, against any objections they have to other aspects of the equity plan, including any "problematic pay practices."

## **Hydraulic Fracturing Proposals ("Fracking")**

### **Key Changes under Consideration**

As it only recently has emerged as a major issue, currently, the ISS policy does not specifically address hydraulic fracturing-related shareholder proposals, being guided instead by their General Environmental Proposals and Community Impact Assessments policy.

Here, they are proposing the following specific hydraulic fracturing policy:

Generally Vote FOR proposals requesting greater disclosure of a company's (natural gas) hydraulic fracturing operations, including measures the company has taken to manage and mitigate the potential community and environmental impacts of those operations, considering:

- The company's current level of disclosure of relevant policies and oversight mechanisms;
- The company's current level of such disclosure relative to its industry peers;
- Potential relevant local, state, or national regulatory developments; and
- Controversies, fines, or litigation related to the company's hydraulic fracturing operations.

## **Political Contribution Proposals**

### **Key Changes under Consideration**

As with fracking, corporate political contributions and their disclosure is a significant emerging issue. The proposed changes would shift ISS' current policy on corporate political contribution disclosure shareholder proposals from CASE-BY-CASE to Generally Vote FOR proposals requesting greater disclosure of a company's political contributions and trade association spending policies and activities. However, the following will be considered:

- The company's current disclosure of policies and oversight mechanisms related to its direct political contributions and payments to trade associations or other groups that may be used for political purposes; including information on the types of organizations supported and the business rationale for supporting these organizations; and
- Recent significant controversies, fines, or litigation related to the company's political contributions or political activities.

## **Reading Between the Lines – Some Positive Changes by ISS May Be Ahead**

While it was not explicitly signaled in the survey itself, it has been reported that ISS representatives have informally stated that it is considering revising its use of grant date values to determine pay.\*\* This is a frequent source of concern to issuers as grant date values represent potential or theoretical – and not actual – pay.

Whether or not ISS makes immediate changes to their equity plan and pay for performance policies, *they finally appear to be "blinking" from absolute defense of SVT, are not totally tone-deaf to issuer criticisms, and may actually adopt a more "holistic" (which many may consider more "real world") approach in the future.*

Because company concerns are being heard, issuers should keep up the drumbeat on these and other areas of concern!

\*\*Latham & Watkins and Semler Brossy Consulting Group October 4, 2011 webinar

## OUR RECOMMENDATIONS FOR COMPANIES:

### Regarding Commenting to ISS:

- Don't fight yesterday's battles, such as trying to convince ISS of the merits of triennial Say on Pay (save that for direct efforts with your investors).
- Instead, focus on areas where ISS may be more malleable, such as appropriate ownership levels and holding periods for proxy access.
- Educate ISS about the uniqueness and diversity of company business models, which naturally becomes reflected in the uniqueness and diversity of their compensation programs. The goal is to continue to wear them off one-size-fits-all compensation guidelines and excessive reliance on SVT and grant date values.

### Additional Actions to Consider:

- Do not reflexively make substantive changes to your governance or compensation practices or related disclosures solely on the basis of their being the subject of potential or even actual ISS policy changes.
- Rather, identify which investors and what reasons prompted negative Say on Pay or Director votes this past year.
- Understand to what extent their votes were driven by ISS or other proxy advisors, or were arrived at internally.
- Identify any governance or compensation practices you are considering changing, particularly if you feel these will benefit your company.
- Enhance disclosures about your board, the director nominees, their qualifications, diversity and independence.
- Similarly, apply "continuous process improvement (CPI)" to improve the clarity and understandability of your company's proxy, compensation and other governance disclosures.

One of the first things we do for clients is review their current ownership base and inform them as to which of their institutional investors' voting is primarily based on proxy advisor recommendations, as opposed to internal policies, guidelines and processes. This analysis becomes the foundation for much of our strategic and tactical advice for managing the proxy process, with the goal of a successful outcome, and also illuminates where your direct efforts at investor engagement will be most fruitful. **Phoenix provides this information to our clients no less than quarterly, and will be pleased to have this type of discussion with other companies upon request.**

## WE CAN HELP YOU PREPARE FOR THESE CHALLENGES!

Phoenix Advisory Partners helps its clients by:

- **Providing** a road-map for effective engagement with the proxy voters at your top institutional investors
- **Quantifying** the likely impact and influence of Proxy Advisors (e.g. ISS, Glass-Lewis) over your unique ownership base
- **Identifying** potential vulnerabilities in your governance profile and board composition
- **Projecting** the vote on a range of potential management and shareholder-sponsored proposals
- **Developing** effective response strategies to activism and negative proxy advisor recommendations
- **Implementing** proven strategies to increase retail voting participation
- **Sharing** best practices from other leading companies

To discuss these issues and how we can assist you, please contact us at:

877-478-5038 (toll-free) [info@phoenixadvisorypartners.com](mailto:info@phoenixadvisorypartners.com) [www.phoenixadvisorypartners.com](http://www.phoenixadvisorypartners.com)

877.478.5038 - [www.phoenixadvisorypartners.com](http://www.phoenixadvisorypartners.com)

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