



ISS Releases its 2012 Policy Changes on November 17, 2011 Effective for Meetings on or after February 1, 2012

Before Making Changes In Response - Know The Impact of ISS Recommendations on Your Unique Ownership Base

On November 17, ISS released a series of policy updates it will apply in the coming year. Some are incremental tweaks to existing policies, while others reflect more fundamental shifts in their methodology. In this alert, we will highlight the most significant of these changes, and provide you with our recommendations in response. These policy changes are the culmination of their annual policy review process which we described to you in our earlier alert dated October 24, 2011.

The most fundamental of these changes reflect areas of long-standing concern on the part of issuers as well as some investors, including their pay-for-performance (PfP) alignment methodology; what some considered excessive focus on the most recent year-over-year CEO pay changes; and their peer group construction methodology. Apparently left unchanged is their use of grant date values to determine pay, which represent “potential” or “theoretical” — and not actual — pay.

Revised Pay-for-Performance Methodology Incorporates Longer Term Perspective:

ISS' PfP methodology is central to their Say on Pay recommendations, is an element of their equity plan review process, and in cases of persistent concerns, can result in recommendations against members of the board compensation committee.

In announcing this longer-term focus, ISS stated that their new approach will “provide clients with a more robust view of the relationship between executive pay and performance at portfolio companies by identifying strong (as well as weak) pay-for-performance alignment over a sustained time period.”

In evaluating PfP alignment, ISS will continue to use a two-stage review:

1. Evaluate the relative alignment between company's TSR rank and the CEO's total pay rank within a peer group, measured over one-year and three-year periods (weighted 40 percent/60 percent), and the absolute alignment between the CEO's pay trend and company TSR over the past FIVE fiscal years.
2. Where alignment appears weak, they will undertake further analysis to determine causal or mitigating factors, including the ratio of performance- to time-based equity awards; ratio of performance-based pay to overall pay; completeness of disclosure and “rigor” of performance goals; the company's peer group benchmarking practices; actual results of financial/operational metrics and other considerations.

A related significant change involves the peer groups they will compare companies to. Previously they used the entire 4 digit GICS (Global Industry Classification System) peer group. This often resulted in comparisons to companies of different sizes and business models, and with which the company does not compete for human capital. Going forward, ISS will still start with the 4 digit GICS industry group, and then narrow this down to 14 – 24 companies with more similar market cap and revenues (or assets if a financial firm) to the company under evaluation.

What This Means to You:

Generally speaking, a longer-term focus should be beneficial to many companies which seek to reward long-term performance, but which have been subject to significant recent stock price volatility. On the other hand, these new procedures may increase uncertainty as to what the result of their analysis will be. ISS indicates that they will provide additional guidance on the 2012 PfP methodology during December, and will also provide more detail and transparency around their new peer group construction.

Despite these present uncertainties, what remains clear is that companies should be telling their best possible compensation story – in clear, compelling and digestible fashion. This can include “proxy statement summaries” at the front of their proxies, plain English CD&A executive summaries including graphics to emphasize the long term and performance-based elements of their plans, discussion of how pay philosophy and administration support the company’s business model and efforts to grow shareholder value, and disclosing specific performance goals by function.

Board Response to High Levels of Negative Voting on 2011 Say on Pay Proposals:

Since last spring, Phoenix Advisory Partners has consistently stated that Say on Pay, evaluation of the vote results, and subsequent company responses is a year-round process. We’ve also consistently said that it’s not just about the approximately 40 companies with “failed” votes, but that many other companies with less-than-stellar results should expect enhanced scrutiny in 2012. We are also mindful that, in the 2011 “year-one” of universal Say on Pay, ISS often applied a “yellow card” of expressing pay concerns by recommending votes against the Say on Pay proposal, and that in 2012, where they have persistent concerns, may increasingly apply the “red card” of recommending votes against (or withhold) from members of the board compensation committee.

For 2012, ISS will recommend “case-by-case” on compensation committee members (and in some cases, the full board) as well as the Say on Pay proposal at companies which received less than 70% favorable votes on the 2011 Say on Pay proposal, and will provide the highest level of such scrutiny at companies which received less than majority support (i.e. failed proposals).

In this “case by case” evaluation, they will go beyond the Dodd-Frank-required discussion in the 2012 CD&A of whether and if so how the board took into account the 2011 Say on Pay vote results. Their enhanced review will also include:

- Company disclosure of engagement efforts with major institutional investors to determine what contributed to the low levels of support;
- Specific actions taken based on this feedback, including changes to compensation practices and their disclosure;
- Whether the areas of concern are isolated or recurring and;
- The company’s ownership structure.

Say on Pay 2011		
Tier (F/F+A+AB)	# of Co's	% of total
0 - 49.9%	37	1.4%
50 - 69.9%	162	6.3%
70 - 79.9%	188	7.3%
80 - 89.9%	406	15.8%
90 - 100%	1776	69.1%

Above is a summary of the Say on Pay results YTD in 2011 for all Russell 3000 companies for which data is available. This would indicate that approximately 200 of these companies will receive enhanced scrutiny from ISS.

Many more companies will receive enhanced scrutiny from their major investors. A number of major institutional investors have said they too will apply enhanced scrutiny in 2011, but at all portfolio companies where they voted against in 2011 – irrespective of the overall vote result. This means that an additional 600 companies in the 70 – 89.9% range may be carefully scrutinized by one or more of their major, long-term institutional owners, who will be looking for changes to whatever areas concerned them last year. Unless these companies identified a) which of their top investors voted against, b) why they did so, and then c) addressed their concerns, these companies can expect continued negative voting on Say on Pay, directors and even escalating forms of activism from these and additional like-minded investors.

What This Means to You:

As a general statement, investors and proxy advisors alike are quick to point out any existing pay or governance practices they may not favor (i.e. snapshot in time), but often have a short memory – or no focus at all – on what recent changes the company has made in transitioning toward evolving best practices (i.e. the moving picture). Rather than playing “defense” and apologizing for particular practices certain investors object to, we encourage companies to take the offense and highlight the various changes to their governance and pay practices they have made in recent years. In other words, remind investors and “take credit” for the distance you have already traveled, and by implication, the direction you are traveling in.

Other Policy Changes Which may Impact Many Companies:

Say When on Pay:

If companies implement Say on Pay on a less frequent basis than the frequency which received a majority of votes cast on the most recent Say When on Pay proposal, ISS will recommend against (or withhold) from the entire board (except new nominees who will be evaluated case-by-case).

If no frequency received a majority of votes cast, and the company implements Say on Pay on a less frequent basis than the frequency which received a plurality of votes cast, ISS will evaluate the board on a case-by-case basis, and consider the board’s rationale for the less-frequent basis, ownership structure, any compensation concerns, and the prior year’s Say on Pay vote results.

Proxy Access Shareholder Proposals:

Anticipating a wave of shareholder sponsored proxy access proposals which may contain widely varying features, ISS is giving itself maximum leeway. They will evaluate each proposal on a case-by-case basis, looking at ownership thresholds (percent and duration), the maximum proportion of directors that can be nominated each year, and other factors. As with their PfP and peer group policies, they indicate that in January 2012 they will provide additional guidance including FAQ’s once they have had a chance to see and evaluate the ‘first wave’ of such proposals.

Political Spending Disclosure:

Particularly as we enter an election year, it is anticipated that many companies will receive proposals seeking disclosure of their corporate political spending policies, practices and oversight. For 2012, ISS has changed its approach from “case-by-case” to “Generally Vote For” proposals seeking disclosure (or greater disclosure) of these policies and practices.

Hydraulic Fracturing:

As the use of this extraction technique is rapidly expanding, so too is the level of scrutiny it is receiving, as well as the related demand for disclosure. Previously covered under ISS' "General Environmental Proposal" and "Community Impact Assessments" policies, they have now created an issue-specific policy for this topic. They will "Generally Vote For" proposals requesting greater disclosure of a company's hydraulic fracturing operations, including measures the company has taken to manage and mitigate the potential environmental impact of those operations. In this review, they will consider the company's current level of disclosure of policies and oversight mechanisms, its level of disclosure relative to industry peers, potential new relevant regulatory developments, and any history of controversy, fines or litigation related to these operations.

Further Information:

The full text of ISS' "US Corporate Governance Policy 2012 Updates" can be found here:

http://www.issgovernance.com/files/ISS_2012US_Updates20111117.pdf

For a comprehensive review of these policy changes and proxy advisor influence generally, contact Phoenix (see below).

OUR RECOMMENDATIONS FOR COMPANIES:

- Do not reactively make substantive changes to your governance or compensation practices or related disclosures solely due to ISS policy changes
- Rather, identify which investors and what reasons drove 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
- Apply "continuous process improvement (CPI)" to improve the clarity of your company's proxy, compensation and other governance disclosures

PHOENIX ADVISORY PARTNERS HELPS OUR 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:

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