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Corporate Governance Update: ISS Policy Updates for 2012 Proxy Season

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As the year comes to an end, companies looking ahead to the 2012 proxy season should be aware of the recently updated corporate governance policies of Institutional Shareholder Services (ISS).[1] While maintaining its formal policy of issuing "case-by-case" evaluations in many areas, ISS has issued numerous revisions of prior policies as well as new policies on certain types of shareholder proposals that had not been previously addressed. The key areas of interest for companies preparing for 2012 are likely to be proxy access, say-on-pay, pay-for-performance, and risk oversight.

Proxy Access

Shareholder proposals on proxy access are likely to be a topic of importance next year due to the Securities and Exchange Commission's (SEC) amendment to Rule 14a-8, effective September 20, 2011. The rule now provides that companies may not exclude proposals for proxy access procedures from their proxy statements on the basis that they relate to the nomination or election of directors. Proponents must meet the current eligibility requirements of Rule 14a-8, which require that the shareholder have owned at least the lesser of $2,000 in market value, or 1 percent, of company shares for at least one year. (Companies may, of course, ask for no-action relief from the SEC to exclude such proposals on other grounds.[2])

ISS's policy regarding proxy access proposals made by shareholders, now including management, will continue to be case-by-case evaluation. That said, the

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[1] Institutional Shareholder Services, Nov. 17, 2011, available at www.issgovernance.com.

[2] Furthermore, in the amendments to Rule 14a-8, the SEC codified prior staff interpretations regarding exclusion of shareholder proposals relating to nomination or election of directors; companies may exclude a proposal if it would disqualify a nominee who is standing for election; would remove a director from office before his or her term expired; questions the competence, business judgment or character of one or more nominees or directors; seeks to include a specific individual in the company's proxy materials for election to the board; or otherwise could affect the outcome of the upcoming election. See Securities Exchange Act Rule 14a-8.

revised policy includes many new, specific factors to be considered in the evaluation by ISS. Factors include both company-specific items, such as size and shareholder demographic, and proposal-specific items, such as the proposal's minimum share ownership thresholds (both percentage and duration), the maximum proportion of directors that shareholders may nominate each year, and the proposed procedures to resolve any conflicts among multiple shareholder nominations. One change is that the proponent's rationale is no longer an enumerated, core factor, though ISS does include a catch-all of "any other factors deemed relevant," which of course would include this item when ISS considers it of importance in a particular case. ISS has indicated that it would give greater scrutiny to proposals for binding bylaw amendments rather than precatory requests for board action.

It is an open question how many proxy access proposals will be made, and whether they will be of the precatory or the binding variety, but ISS certainly expects to see them and has stated that it will provide additional guidance on the specific terms of proposals in a January 2012 update, based on a review of proposals made up to that time. Companies should pay attention to this update when it becomes available and generally keep a close watch on developments in this area. Companies may also consider proposing preemptive proposals on proxy access in certain situations but this will require advance planning and thoughtful implementation.

Say-on-Pay

Say-on-pay continues to be an important topic for the 2012 proxy season. For 2012, ISS will evaluate on a case-by-case basis both say-on-pay proposals and compensation committee member elections (and, in exceptional cases, full board elections) where a company's say-on-pay proposal in 2011 received the support of less than 70 percent of the votes cast. ISS will take into account the company's response to the concerns expressed by shareholders in the previous year, including disclosure of engagement efforts with major institutional investors, the company's ownership structure, whether the issues were recurrent or isolated, and any specific actions taken to address the issues that led to the lack of 70 percent support. ISS notes that cases where support was less than 50 percent will "warrant the highest degree of responsiveness." Given that a 30 percent threshold of opposition votes triggers a more stringent review, companies may take the view that, in order to win a say-on-pay vote, they need to garner at least 70 percent support as opposed to a simple majority of the votes cast.

It is more important than ever for companies to have a thoughtful strategy in place for winning the say-on-pay vote by a significant margin. Moreover, companies that received less than 70 percent support in 2011 should take these new policies into account when planning for the 2012 proxy season. ISS advises companies in this position to discuss in their disclosures company outreach efforts to major institutional investors and provide information regarding their discussions, outlining the specific actions taken by their boards of directors to address the compensation issues that resulted in significant opposition votes. ISS has established a process to engage with company representatives that is described on its website and may be useful to companies in all stages.[3]

ISS also will evaluate the board response to the results of votes regarding the frequency of advisory say-on-pay votes. Under the Dodd-Frank Wall Street Reform & Consumer Protection Act, companies are required to hold advisory say-on-pay votes, and to provide shareholders with an advisory vote to choose the preferred frequency of say-on-pay votes at the first shareholder meeting on or after January 2011, and at least every six years thereafter. Shareholders were allowed to vote to hold say-on-pay votes every one, two, or three years. Though the vote was precatory, ISS believes that boards should abide by the shareholders' choice as to frequency; as a result, ISS will recommend voting against or withhold on the entire board of directors (albeit on a case-by-case basis with respect to new nominees) if the board implements an advisory say-on-pay vote less frequently than the option chosen by the majority of votes cast at the most recent vote.[4]

Pay-For-Performance

In order to focus on evaluating pay relative both to peers and to shareholder return trends, ISS has refined its pay-for-performance methodology for 2012. Previously, if a company fell in the bottom half of its Global Industry Classification Standard (GICS) industry group in total shareholder return over both a one-year and three-year period, and the CEO's pay was not aligned with shareholder performance over time (with particular emphasis on the immediately preceding year), ISS generally would recommend a negative say-on-pay vote. The new policy selects a narrower peer group of 12 to 24 companies, using as guidelines market capitalization and revenues (or assets, for financial firms) within the applicable GICS group. While not perfect, this is a much needed change, as it was often noted that the automatic use of a company's GICS group as the applicable benchmark could lead to misleading peer group performance rankings. The revised policy also measures the relative alignment between CEO pay and company total shareholder return (TSR) within the peer group for a one- and three-year period (with a 40 percent emphasis on the one-year period and a 60 percent emphasis on the three-year period), as well as absolute alignment between CEO pay and company TSR over a five-year period. Where this alignment is perceived by ISS to be weak, ISS will consider how a number of factors affect alignment of pay with shareholder interests, such as a company's benchmarking practices, completeness of disclosure and ratio of performance based pay to overall compensation.

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[3] See www.issgovernance.com/policy/engagingwithISS.

[4] If no majority was possible because more than two options were offered, and the board implements an option other than the one chosen by a plurality of votes cast, ISS will consider its recommendation on a case-by-case basis.

Perhaps recognizing that these policy revisions are both significant and potentially confusing, ISS has provided additional guidance on its 2012 pay-for-performance methodology in a technical document that became available late December.[5] This document offers details of ISS' quantitative methodology and a discussion of its qualitative evaluation.

Risk Oversight

ISS has expanded the factors it will consider in recommending "no" or "withhold" votes in uncontested director elections, now specifically adding material failures of risk oversight to the list. ISS specified that this addition is not intended to "penalize boards for taking prudent business risks or for exhibiting reasonable risk appetite," but does not elaborate as to how it will distinguish, in hindsight, between such situations and more fundamental and systemic shortcomings. In light of uncertainty in this area, companies should review their risk oversight policies and take steps to provide appropriate disclosure. Companies that have struggled recently in ways that could be seen as attributable to poor risk management may wish to present their view of the situation in discussions with significant shareholders and possibly in written disclosures as well. Board of director responses to such situations should be a key factor in determining how ISS evaluates the situation in hindsight.

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The revisions to ISS' policies for the 2012 proxy season are important. Companies should consider carefully whether some ISS recommendations will change even absent any change in their corporate performance, executive pay, or frequency of say-on-pay votes. Early engagement of proxy solicitation firms is essential. As always, communication, both with shareholders and, if appropriate, with ISS, is of paramount importance, as is thoughtful advance preparation.

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[5] Institutional Shareholder Services, "Evaluating Pay for Performance Alignment: ISS' Quantitative and Qualitative Approach, Dec. 20, 2011, available at http://www.issgovernance.com/sites/default/files/EvaluatingPayForPerformance_20111219.pdf.