

New ISS Policies Overhaul Say-on-Pay Analysis

ISS's annual policy update, released this month in anticipation of the 2012 proxy season, revises existing policies and adopts new ones to respond to current developments. The policy changes will be effective for meetings on or after February 1, 2012.

Executive Compensation

Heightened Scrutiny Based on 2011 Vote. Winning a say-on-pay vote is not enough. Anything less than a strong majority—at least 70% of votes cast—in 2011 will cause ISS to take a closer look at the election of compensation committee members (and, in exceptional cases, the full board) and the company's say-on-pay proposal for 2012, taking into account:

- the company's response, including engagement with major institutional investors regarding the issues that contributed to the low level of support, specific actions taken to address the issues, and the company's other recent compensation actions;
- whether the issues raised are recurring or isolated; and
- the company's ownership structure.

Scrutiny will be especially close for the relative handful of companies that received less than majority support in 2011. According to ISS, as of September 1 there were 38 such companies in the Russell 3000, eight of which are in the S&P 500.

New Pay-for-Performance Analysis for All Companies. Responding to widespread criticism of its 2011 say-on-pay analytical framework, ISS has adopted a modified pay-for-performance analysis including both relative peer group alignment and absolute alignment.

First, ISS will compare each company against an ISS-constructed peer group generally comprised of 14 to 24 companies that will be selected using market cap, revenue (or assets for financial firms) and Global Industry Classification (GIC) group. ISS will provide more on its proposed peer selection approach in a set of updated Q&As that it will publish in December, but a company likely will not be able to predict its ISS peer group until after it files its proxy and ISS generates its report. ISS will consider the company's rank for both pay and total shareholder return (TSR) within the peer group for one and three year look-back periods, and will also compare the CEO's pay to the median pay in the peer group.

Next, ISS will analyze the absolute alignment between the trend in CEO pay and company TSR over a five year look-back, measured by the difference between the trend in annual pay changes and the trend in annualized TSR during the period. If this analysis indicates a significant lack of alignment, ISS will consider several qualitative factors to determine how various pay elements may work to encourage or undermine long-term value creation and alignment with shareholder interests. Examples of such qualitative factors include:

- the mix of performance-based and time-based equity awards;
- the ratio of performance-based compensation to overall compensation;
- actual results of financial/operational metrics (e.g., growth in revenue, profit, cash flow), both absolute and relative to peers; and
- special circumstances related to, for example, a new CEO in the prior fiscal year or unusual equity grant practices (e.g., biennial awards).

This new approach, although less crude than the 2011 methodology, is more complex and less predictable. The prior approach focused on companies with TSRs in the lower 50% of their GIC groups over the one and three year look-back periods, and applied a critical analysis if CEO compensation had increased in the previous year despite the company's TSR standing. Companies with TSRs in the top 50% of their GIC groups were much less likely to have the dreaded "pay for performance disconnect." ISS's new approach will take a longer-term perspective by weighting 60% of the look-back to the three year period and 40% to the one year period and by applying a separate analysis on a five year basis.

One of the criticisms of ISS's prior methodology has been that, although TSR was measured over one and three years, compensation was derived primarily from the proxy table reflecting the prior year's compensation. This focus gave rise to a host of distortions because, among other things, it tended to compress into a single year the impact of equity grants that might vest over several years or not at all. ISS indicates that the qualitative factors in its new methodology will address this.

Frequency of Say-on-Pay Votes. ISS will recommend voting against or withhold from the entire board, other than new nominees, if the board adopts a frequency for the say-on-pay vote that is less frequent than the choice of the majority of votes cast. If the board selects a less frequent basis than the one that received a plurality (but not a majority) of the votes cast, then ISS will make a recommendation on a case-by-case basis taking into account: (a) the board's rationale; (b) the company's ownership structure and vote results; (c) compensation concerns or a history of problematic practices; and (d) the support level for the say-on-pay vote.

As a practical matter this will rarely be an issue as only a handful of companies have announced a frequency that was not supported by a majority of votes cast. If a board chooses to hold a say-on-pay vote *more* frequently than the frequency supported by a majority of shareholders (a rare but not unprecedented case), then ISS considers this "good governance" and there are no negative implications.

Board and Governance

Proxy Access. ISS will recommend case-by-case on any proposal (shareholder or management) to implement proxy access, taking into account: (a) company-specific factors; (b) proposal-specific factors, such as the ownership thresholds proposed, the maximum proportion of directors that shareholders may nominate each year; and (c) the method of determining which nominations appear on the ballot if multiple shareholders submit nominations.

ISS policy acknowledges that this list of factors is unhelpfully vague, but says that the policy is meant to be sufficiently flexible to anticipate the variety of proxy access proposals that it anticipates for the season. ISS indicates that it will provide additional guidance in January 2012 after examining specific proposals.

We and others in the governance community expect a meaningful number of proxy access proposals to be submitted this coming year, with activists conducting exploratory campaigns to determine which approach gets traction with investors. Our recent [blog post](#) discusses the two proposals submitted so far.

Exclusive Venue Proposals. In response to the recent momentum behind exclusive forum provisions requiring that specified classes of litigation be brought exclusively in the state court of the company's state of incorporation, ISS has updated its policy and will recommend a vote on a case-by-case basis based on:

- whether the company has been materially harmed by shareholder litigation outside its corporate jurisdiction, based on proxy statement disclosure; and
- whether the company has an ISS-designated list of "good governance" features including: (a) a declassified board; (b) majority voting; and (c) the absence of a non-shareholder approved poison pill.

The previous ISS policy was based solely on the company having the checklist governance features, including those specified above but also including the ability for 10% of shareholders to call special meetings. This last requirement has been dropped, but the addition of a factor based on whether the company has been materially harmed in the past by out-of-state shareholder litigation is a curious development. See our recent [blog post](#) discussing the issue.

Dual-Class Structures Created by a New Class of Common Stock. ISS has changed its policy of generally supporting proposals to create new classes of nonvoting or lesser voting common stock. Instead, it will recommend voting against proposals to create any new class of common stock unless:

- the company discloses a compelling rationale such as: (a) auditors' concerns about the company's ability to continue as a going concern or (b) the new shares will be transitory;
- the new class is intended for financing purposes with minimal or no dilution to current shareholders; and
- the new class does not preserve or increase the voting power of an insider or a significant shareholder.

Social and Environmental

The new social and environmental policies reflect increased public attention on a variety of issues *du jour*.

Hydraulic Fracturing. ISS will recommend for proposals requesting greater disclosure of a company's hydraulic fracturing operations, considering:

- the company's current disclosure about its policies and oversight mechanisms;
- disclosure relative to industry peers;
- regulatory developments; and
- controversies or litigation relating to the company's fracturing operations.

Political Spending and Lobbying. In response to activists' increasing calls for more disclosure on political spending, ISS will now recommend voting for proposals requesting greater disclosure of a company's political contributions and trade association spending policies and activities, considering:

- the company's current disclosure on policies and oversight mechanisms, including information on the types of organizations supported and the business rationale; and
- significant controversies, fines or litigation related to the company's political contributions activities.

Proposals requesting information on lobbying activities will be evaluated on a case-by-case base, using the same criteria as above for political contributions, but also including as a consideration the impact that the policy issues may have on the company's business activities. ISS has clarified that the policy applies to proposals addressing broader efforts to sway public opinion and not simply formalized lobbying. The policy appears to cover more recent proposals seeking company reports on lobbying activities. Those proposals reflect activists' views that companies are conducting indirect campaigns, either through trade associations or otherwise, to influence public opinion, including communication efforts to the general public relating to legislation or elections.

Others. ISS will recommend case-by-case on proposals seeking a comprehensive recycling strategy, requests for workplace safety reports and reports on water-related concerns.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

Ning Chiu	212 450 4908	ning.chiu@davispolk.com
Edmond T. FitzGerald	212 450 4644	edmond.fitzgerald@davispolk.com
William M. Kelly	650 752 2003	william.kelly@davispolk.com
Richard J. Sandler	212 450 4224	richard.sandler@davispolk.com

© 2011 Davis Polk & Wardwell LLP

Notice: This publication, which we believe may be of interest to our clients and friends of the firm, is for general information only. It is not a full analysis of the matters presented and should not be relied upon as legal advice. If you would rather not receive these memoranda, please respond to this email and indicate that you would like to be removed from our distribution list. If you have received this email in error, please notify the sender immediately and destroy the original message, any attachments thereto and all copies. Refer to the firm's [privacy policy](#) located at davispolk.com for important information on this policy. Please add Davis Polk to your Safe Senders list or add dpwmail@davispolk.com to your address book.