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2012 Proxy Season: What to Expect from ISS

As companies diligently prepare for the 2012 proxy season, they need to be mindful of changes that proxy advisors are making to their voting policies. Institutional Shareholders Services (ISS) recently released its draft policy changes for 2012, which include significant revisions to its methodology for evaluating management say-on-pay (SOP) proposals. Although ISS is accepting comments on its proposed policy changes through the end of October, it is unlikely that there will be any material modifications to them when finalized in November. Below are the key updates issuers can expect from ISS for 2012.

Pay-for-performance methodology

Issuers will see the greatest impact in the pay-for-performance (PFP) methodology ISS uses in evaluating SOP proposals. A number of the changes ISS is making address criticisms raised by companies during the 2011 proxy season over its current methodology. This consisted of screening out firms whose one- and three-year total shareholder returns (TSR) were below the peer group median, and then examining the company's pay practices and trends, such as whether or not the CEO's pay increased in the past year.

Key features of ISS's new PFP methodology include:

- **Two quantitative PFP analyses with a 50/50 weighting**: An *absolute analysis* will look at the company's CEO pay and total shareholder returns (TSR) in isolation, and a *relative analysis* will examine the company's CEO pay and TSR performance against peers.
- **Greater emphasis on long-term performance**: The relative analysis will rank the company's CEO pay and TSR performance within its peer group over one and three years, but the three-year period will be given greater weighting (60%) than the one-year period (40%). The absolute analysis will examine the trend of the company's CEO pay and TSR performance over five years.
- **More refined peer groups**: Peer groups will consist of 14-24 companies and be selected based on similarity in market capitalization, revenue (or assets for financial firms) and industry. Currently, ISS uses generic peer groups based on four-digit GICS codes.
- **Identification of over-the-top payors:** As part of the relative analysis, ISS will evaluate the company's CEO pay as a multiple of the peer group median, irrespective of performance. Unlike the current methodology which scrutinizes CEO pay if a company is underperforming its peer group, this test will capture companies that are outperforming peers, but may still be paying outlandish amounts relative to the high performance.

Overall, issuers should feel heartened by these refinements, which may give a more realistic appraisal of long-term pay and performance alignment. However, companies may still take issue with aspects of ISS's pay methodology that didn't get changed. These include ISS's focus on TSR as the sole performance metric and its valuation of CEO stock option awards based on their potential value at grant date rather than their actual value when exercised.

ISS stated that it doesn't expect the new PFP methodology to result in a greater number of against recommendations on SOP than in 2011. Nevertheless, in preparing for proxy season, companies should examine how their TSR performance and pay programs will hold up under ISS's new methodology. Because the choice of peers can greatly impact the analysis (ISS's relative analysis carries a 50% weighting), issuers should try to find out in advance what peer companies ISS has selected for them.

Compensation committees on the hot seat

As anticipated, ISS may recommend against compensation committee members if there was significant opposition to the company's SOP in 2011 and the company does not adequately disclose how it has responded to the vote and shareholder concerns. In such an instance, ISS expects companies to disclose their outreach efforts to major institutional investors, as well as steps they have taken or plan to take to rectify pay issues. While ISS doesn't clarify "significant" opposition, issuers should conservatively assume it applies where support was less than 80% of the votes cast for and against the SOP proposal.

While less prevalent, ISS is taking a tough approach to companies that adopt a *less frequent* interval for SOP votes than what shareholders chose in their 2011 say-when-on-pay (SWOP) votes. If the board's decision goes against the will of a majority of votes cast, all of the incumbent directors will face a withhold/against recommendation. In cases where shareholders' preference was evidenced by a plurality but not a majority of votes cast, ISS will decide case-by-case whether or not it will recommend against the board. That will incorporate factors such as the board's rationale for its decision and whether or not there are any ongoing compensation issues that would warrant a more frequent pay vote.

Proxy access proposals

Short of giving explicit guidance, ISS has outlined the factors it will take into consideration when evaluating shareholder proposals to adopt proxy access. These include the proponent's rationale for targeting the company and the contours of the proxy access regime suggested by the proponent (the percentage and duration of share ownership, the number of directors that may be nominated, and how nominee submissions from multiple shareholders will be handled).

It is unclear at this point whether ISS will largely be supportive of any reasonable proxy access proposal or whether it will take a more discerning approach and only support shareholder proposals at companies with serious oversight problems. Judging from its August 2009 comment letter on the SEC's proposal, issuers should assume that ISS will lean toward supporting shareholder-sponsored proxy access proposals. As to the parameters of a proxy access regime, ISS's comment letter offers some insight into its preferences:

- **Amount of ownership**: In determining nominator eligibility, ISS supported the SEC's sliding scale ownership approach based on company size (net assets), as well as allowing shareholders to aggregate their holdings to meet the requirement. The SEC proposed 1% for large firms, 3% for mid-sized firms, and 5% for small firms. ISS felt 5% was too high for small firms.
- **Length of ownership**: ISS favored a one- to two-year stock ownership holding period.

- **Number of permissible nominees**: ISS supported the SEC's proposal to limit the number of shareholder nominees to 25% of the board. Where the board is staggered, ISS felt the limit should apply to the full board size, not just the seats up for election.
- **Multiple shareholder nominators**: Where there are multiple nominators and the shareholder nominees exceed the maximum, ISS favored giving priority to the shareholder with the largest ownership stake rather than the one which filed its nominees first.

Other ISS policy changes

Other ISS policy changes primarily relate to specific types of companies:

- **Equity plans at IPO companies**: At newly public companies that are submitting their equity plans to shareholders for the first time to qualify for 162(m) tax treatment, ISS will conduct its standard equity plan analysis in making its recommendation.
- **Hydraulic fracturing:** ISS will generally support shareholder proposals seeking greater disclosure of a company's natural gas hydraulic fracturing operations.
- **Political contributions**: ISS will generally support shareholder proposals seeking greater disclosure of a company's political spending and related policies.

We note that the latter two policy changes simply codify ISS's actual practices. In 2011, ISS supported all five shareholder proposals on hydraulic fracturing. It supported all but 11 of the 52 shareholder proposals on ballots on political contributions. Those that it rejected dealt with matters such as an annual shareholder advisory vote on political spending, political non-partisanship in the workplace, reporting political contributions in major newspapers, and reporting on lobbying in support of cap-and-trade legislation and the "ObamaCare" Patient Protection and Affordable Care Act.