ISS 2012 U.S. PROXY VOTING GUIDELINES: ARE YOU PAYING FOR PERFORMANCE?

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To Our Clients and Friends:

Institutional Shareholder Services, Inc. ("ISS") recently released its 2012 U.S. Proxy Voting Summary Guidelines (the "2012 Guidelines"), which are effective for meetings held after February 1, 2012.[1] The guidelines, which are intended to assist institutional shareholders in voting the shares of their publicly held portfolio investments, are generally consistent with the 2011 guidelines, with the vast majority of changes in the compensation area. Among the material updates from last year's guidelines are the following voting recommendations:

- **Executive Compensation.** Generally vote "case-by-case" on advisory "say-on-pay" votes, but vote "against" on advisory say-on-pay votes or, in certain circumstances, on members of the compensation committee and potentially the full board if there is significant "pay-for-performance" misalignment, *i.e.*, if there is significant misalignment between CEO pay and company performance. As discussed in further detail below, ISS's new approach measures pay-for-performance quantitatively, by comparing CEO pay relative to both company total shareholder return ("TSR") and industry peers (based on both peer group TSR and CEO pay multiples), and qualitatively. If there is pay-for-performance misalignment and there is an equity compensation plan on the ballot, ISS may also recommend an "against" vote on the equity plan.

- **Board Responsiveness to Say-on-Pay Votes.** Vote "against" or "withhold" on the board or compensation committee if they failed to "adequately respond" to a previous say-on-pay proposal that received the support of less than 70% of the votes cast or if they do not allow say-on-pay votes at the frequency that received the support of the majority of votes cast. Board responsiveness on these items may also impact, on a "case-by-case" basis, votes on executive pay.

- **Incentive Bonus Plans.** Vote "against" on proposals to approve incentive cash and/or stock bonus plans for purposes of preserving the deductibility of compensation under Section 162(m) of the Internal Revenue Code if the plan contains "excessive problematic provisions." Vote "case-by-case" on such proposals if the proposal also seeks approval on

1 *The 2012 Guidelines are available at http://issgovernance.com/files/2012USSummaryGuidelines.pdf*

amendments such as an increase in available shares, an increase in plan participants or the extension of option terms, or if it is the first time the plan is being submitted for approval following an IPO.

- Proxy Access. Vote "case-by-case" on proposals to enact proxy access procedures for shareholders to nominate new directors taking into account, among other factors, company-specific and proposal-specific factors. Proposal-specific factors may include (1) the minimum thresholds for percentage and duration of shareholder ownership, (2) the maximum proportion of directors that shareholders may nominate each year and (3) the proposed process for choosing which nominations should appear on the ballot when multiple shareholders submit nominations. Although ISS did not set forth specific parameters for proxy access in the 2012 Guidelines, it expressed its general support for proxy access as an important shareholder right.
- Political Spending and Lobbying Activities. Generally vote "for" on proposals requesting greater disclosure of political spending and lobbying activities. However, in assessing its recommendation, ISS will consider a company's current disclosure and political spending history.

In addition, the 2012 Guidelines contain updated "burn rate" tables, which show the rates at which ISS expects equity compensation plan shares to be utilized by companies within each Global Industry Classification Standard ("GICS") industry group. If a company exceeds its industry group's three-year burn rate cap by more than a specified threshold, ISS will generally recommend a vote "against" any equity plan that is on the ballot.

The 2012 Guidelines also add recommendations on proposals relating to dual class structures (generally "against"), exclusive venue ("case-by-case"), hydraulic fracturing (generally "for" requests for greater disclosure), workplace safety ("case-by-case"), water issues ("case-by-case") and below NAV stock sales by business development companies (generally "for" provided ISS standards are met).

NEW APPROACH TO ASSESS PAY FOR PERFORMANCE

For the second proxy season of say-on-pay voting, ISS has unveiled what it bills as a "new approach to evaluating pay for performance." The new approach is briefly described in the 2012 Guidelines and is covered in more detail in a separate white paper.[2] For companies in the Russell 3000 Index, ISS will start with a quantitative analysis and evaluate (1) the alignment

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2 *The white paper is available at http://www.issgovernance.com/sites/default/files/EvaluatingPayForPerformance_20111219.pdf*

between the CEO's total pay and TSR in comparison to an ISS-constructed peer group, during one- and three-year measuring periods, (2) the CEO's pay compared to the median of the peer group's CEO pay during the same periods and (3) the CEO's total pay in comparison to the company's TSR during a five-year measuring period. If the ISS testing methodology flags a company's CEO compensation as misaligned with its performance based on the quantitative analysis, ISS will then engage in a qualitative analysis to determine whether there are mitigating factors or to identify the likely source of the misalignment.

Pay Measurement. ISS will measure a CEO's total pay based on the compensation disclosed in the Summary Compensation Table in the company's proxy statement. However, ISS will value certain equity-based awards using a standard set of assumptions it has not identified. ISS will limit its analysis to the pay of the CEO and will not evaluate the pay of other executives.

Peer Group. A significant part of ISS's quantitative analysis will be the peer group it constructs for each company. The peer group will consist of 14 to 24 companies selected based on industry (using GICS groups), revenue and market value. Assets will be used in lieu of revenue for financial companies. However, ISS has identified approximately 25 non-financial companies that will comprise their own peer group and be compared to one another because they are too large to be compared to other companies within their industry. Appendix I to the white paper details the process of selecting peer group companies.

Mitigating Factors. If ISS's quantitative analysis identifies a company with pay-for-performance misalignment, it will then engage in a qualitative analysis and look for possible mitigating factors which may justify or excuse the current misalignment. Factors ISS will consider may include:

- the company's emphasis on performance compensation and the level of its related disclosure;
- the results of financial or operational metrics other than TSR, such as growth in revenue, profit, cash flow, etc.; and
- special circumstances, such as the hiring of a new CEO or unique equity grant practices that may distort ISS's quantitative analysis.

WHAT TO DO NOW?

As companies prepare for the 2012 proxy season, they should take the time to analyze how their CEO's compensation will fare under ISS's new quantitative analysis of pay-for-performance methodology. Although it may not be possible to accurately replicate ISS's new analysis due to possible adjustments from ISS in constructing the peer group and valuing equity grants, a rough analysis will be helpful in identifying potential issues. Companies suffering from the lackluster economic environment that need to maintain high compensation levels to retain their executives are at particular risk of being flagged by ISS's quantitative evaluation. Companies that do not meet the quantitative thresholds need to take special care to justify their compensation by highlighting in their compensation discussion and analysis section ("CD&A") potential mitigating factors for ISS to consider as part of its qualitative analysis.

In addition, companies may want to review whether they received the 70% ISS support threshold on last year's say-on-pay proposal. Companies that received the support of less than 70% of the votes cast on last year's say-on-pay proposal will, if they have not already done so, need to take immediate steps to address shareholder concerns and include disclosure about the steps taken to address those concerns in their CD&A in this year's proxy.

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Please do not hesitate to call us if you have any questions.

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