ALERT

January 9, 2019

ISS PUBLISHES FAQS FOR THE 2019 PROXY SEASON

In December 2018, ISS released U.S. Compensation Policies Frequently Asked Questions (FAQs) and U.S. Equity Compensation Plans FAQs. These documents expand on the 2019 compensation policy updates and preliminary FAQs that were published back in November.[1] Included in the FAQs are updates to ISS' list of problematic pay practices, a revised methodology to identify non-employee director pay outliers, a new "excessive dilution" override factor, and other modifications/clarifications to its compensation and equity plan evaluations.

These policies and FAQs apply to public U.S. companies with annual shareholder meetings on or after February 1, 2019.

U.S. Pay-for-Performance Evaluation

ISS Policy Item	2019 Policy Update
Quantitative Pay-for-Performance Test	• There will be no changes to the quantitative screens for 2019. • ISS' current quantitative test for Russell 3000 companies consists of four components, three relative assessments, and one absolute assessment. ➢ The Relative Degree of Alignment (RDA) component compares percentile ranks of three-year CEO pay to three-year total shareholder return (TSR) using ISS' peer group for a company; ➢ The Multiple of Median (MOM) component compares one-year CEO pay to the one-year median CEO pay for ISS' peer group for a company; ➢ The Pay-TSR Alignment (PTA) component evaluates the five-year CEO pay trend for a company compared to its five-year TSR trend; and ➢ The Financial Performance Assessment (FPA) component, a secondary measure applied after the RDA, MOM, and PTA screens have been calculated, compares a company's percentile ranks of three-year CEO pay and three-year financial performance across three or four financial metrics relative to ISS' peer group for a company.

[1] See FW Cook Alert dated November 29, 2018.

ISS Policy Item	2019 Policy Update
Quantitative Pay-for-Performance Test (continued)	• The FPA screen will continue to use GAAP/accounting performance measures (i.e. return on invested capital, return on equity, return on assets, EBITDA growth, and growth in cash flow from operations). • To add additional insight to financial performance, Economic Value Added (EVA) measures will be displayed in ISS research reports on a phased-in basis over the 2019 proxy season, although not as part of the quantitative pay-for-performance screen.
Front-loaded Awards	• ISS is unlikely to support front-loaded grants that cover more than four years (i.e. the grant year plus three future years). ISS views very large awards that are intended to cover future years of grants as limiting the board's ability to meaningfully adjust future pay opportunities in the event of unforeseen events or changes in either performance or strategic focus. As front-loaded awards often provide for large pay opportunities, ISS will more closely scrutinize pay-for-performance considerations, including completeness of disclosure, emphasis on transparent and rigorous performance criteria, commitments not to grant additional awards over the covered period (ISS states that commitments "should be firm"), and stringent vesting provisions that limit windfall risk.
Preference for Incentive Metrics	• Despite ISS' reliance on TSR for its quantitative CEO pay-for-performance analyses, ISS publicly stated that they do not endorse or prefer the use of TSR or any specific metric in executive incentive programs. ISS acknowledged that the board and compensation committee are generally best qualified to determine the incentive plan metrics that will encourage executive decision-making that promotes long-term shareholder value creation.

U.S. Problematic Pay Practices

ISS Policy Item	2019 Policy Update
"Problematic" Good Reason Definition	• The list of "problematic" pay practices that will likely result in an adverse Say-on-Pay recommendation now includes new or materially amended agreements that provide for "problematic" good reason definitions that present windfall risks, such as "definitions triggered by potential performance failures." • ISS finds a good reason definition to be problematic if it is triggered by potential performance failures, including a company bankruptcy or delisting.

ISS Policy Item	2019 Policy Update
“Problematic” Good Reason Definition (continued)	➢ In discussions following the FAQ release, ISS has clarified that delisting is not intended to constitute a “problematic” good reason definition in the context of going private, but is intended to be “problematic” if it is because of a performance failure, such as failure to maintain a minimum stock price. • ISS disclosed in a subsequent FAQ update that “failure to assume” an agreement by a successor will not be treated as a “problematic” good reason trigger.
Contract Auto-Renewals/Extensions	• Although not highlighted as an update in the compensation policy FAQs, we note that ISS also supplemented its guidance on automatically renewing/extending contracts to clarify that an amendment is considered "material" if it involves any change that is not merely administrative or clarifying. ➢ If any modification to an automatically renewing/extending contract is administrative in nature, its automatic extension will not on its own result in an adverse Say-on-Pay vote recommendation, even where the agreement contains a problematic pay practice. • This ISS position makes it critical to verify that any changes to agreements with grandfathered practices (e.g., gross-up payments), be merely administrative or clarifying - even an amendment diminishing executive rights would appear to lose the grandfather protection.
Smaller Reporting Company[2] (SRC) Disclosure	• ISS is unlikely to support a Say-on-Pay proposal if compensation disclosure is such that shareholders cannot meaningfully assess the board’s compensation philosophy and practices. ➢ SRCs with scaled-back compensation disclosure requirements should continue to provide sufficient disclosure to enable investors to make an informed Say-on-Pay vote.
Program Modifications Made Due to Change in IRC Section 162(m)	• ISS confirmed that shifts away from performance-based compensation to discretionary or fixed pay elements will be viewed negatively.

[2] Effective 9/10/18, the SEC amended the “smaller reporting company” (SRC) definition. Generally, a company qualifies as an SRC if it has public float of less than $250 million or it has less than $100 million in annual revenues and no public float or public float of less than $700 million. The scaled disclosure requirements for SRCs include a less extensive narrative disclosure than required of other reporting companies, particularly in the description of executive compensation.

U.S. Non-Employee Director Pay

<table>
<tr><th>ISS Policy Item</th><th>2019 Policy Update</th></tr>
<tr><td>Excessive Levels of Non-Employee Director (NED) Pay</td><td>
Last year, ISS announced a policy to potentially issue adverse vote recommendations for board members responsible for approving/setting NED pay when there is a recurring pattern of excessive pay magnitude without a compelling rationale. Adverse recommendations may result when excessive NED pay is identified in two or more consecutive years.
Following a quantitative identification of a NED pay outlier, a qualitative evaluation of the company's disclosure will determine if concerns are adequately mitigated.
Adverse recommendations will not be issued under this policy until meetings occurring on or after Feb. 1, 2020 (i.e. for companies where ISS has identified excessive NED pay without compelling rationale in both 2019 and 2020).
In evaluating the company's disclosed rationale, the following circumstances, if within reason and adequately explained, could mitigate concern around high NED pay:

Onboarding grants for new directors that are clearly identified to be one-time in nature;
Special payments related to corporate transactions or special circumstances (e.g. special committee service or requirements related to extraordinary need); or
Payments made in consideration of specialized scientific expertise (e.g. biotech/pharma).

Payments in connection with separate consulting agreements will be assessed case-by-case with particular focus on the company’s rationale. Note that payments to reward general performance/service will usually not be viewed as compelling rationale.
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<tr><td>Methodology to Determine Non-Employee Director Pay “Outliers”</td><td>
Pay outliers defined as representing individual NED pay figures above the top 2-3% of all comparable directors.
ISS will compare individual NED pay totals within the same index and sector. Directors will be compared to other directors within the same two-digit GICS group and within the same index grouping.

Index groupings: S&P 500, combined S&P 400 and S&P 600, remainder of the Russell 3000 Index, and the Russell 3000-Extended.

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ISS Policy Item	2019 Policy Update
Methodology to Determine Non-Employee Director Pay "Outliers" (continued)	• The revised methodology recognizes that board-level leadership positions (i.e. non-executive chairs and lead independent directors) often are recognized with a pay premium as compared to other directors. ➢ For non-executive directors who serve in these board leadership positions, the policy will identify outliers as compared to others within the same category of board leadership, index and sector. • The revised methodology also considers limited instances of narrow distributions of NED pay within any particular sector/index grouping. • In groups where there is not a "pronounced difference" in pay magnitude between the top 2-3% of directors and the median director, this may be considered as a mitigating factor. Note that ISS did not define what would represent a "pronounced difference" in pay magnitude.

U.S. Equity Compensation Policy

ISS Policy Item	2019 Policy Update
Equity Plan Scorecard (EPSC) Evaluations – *Change-in-Control (CIC) Vesting Factor*	• In the Plan Features pillar, the CIC vesting factor is updated to award points based on disclosure of CIC vesting provisions in the plan document, rather than prior policy that was based on the awards' actual vesting treatment. • Full points will be earned if the plan discloses the CIC vesting treatment for both time- and performance-based awards. If the plan is silent on the CIC vesting treatment for either type of award, or if the plan provides for discretionary vesting for either type of award, then no points will be earned. ➢ Note that ISS has removed any preferred CIC vesting approach. Full points are provided if the plan specifies treatment upon CIC in contrast with prior methodology where full points were only earned for certain vesting treatment (e.g., no automatic acceleration for time-based awards, pro-rated vesting or vesting based on actual performance for performance-based awards).
ISS Policy Item	**2019 Policy Update**
Equity Plan Scorecard (EPSC) Evaluations – *New Dilution Override Factor*	• If an equity plan is deemed to be "excessively dilutive," ISS may recommend "Against" regardless of the EPSC results. This overriding factor will be triggered when dilution is more than 20% for S&P 500 companies, or 25% for Russell 3000 (Non-S&P 500) companies. The new policy does not apply to Non-Russell 3000, recent IPOs/spins, or bankruptcy emergent companies.

ISS Policy Item	2019 Policy Update
Equity Plan Scorecard (EPSC) Evaluations – *New Dilution Override Factor (continued)*	➢ Dilution is calculated as: (A + B + C) ÷ CSO, where: A = # new shares requested; B = # shares that remain available for issuance; C = # unexercised/unvested outstanding awards; and CSO = common shares outstanding. ➢ This new overriding factor could negatively impact ISS recommendations for companies that maintain significant broad-based equity grant practices or have considerable unexercised/unvested equity outstanding. • Excessive dilution joins three previously identified factors that may warrant an ISS "Against" vote recommendation despite an above-threshold EPSC score. The other three factors are: (1) awards that vest in connection with a liberal change-in-control definition, (2) plans that permit repricing or cash buyout of underwater stock options without shareholder approval, and (3) the plan is a vehicle for problematic pay practices or a pay-for-performance disconnect. ➢ ISS also reserves the right to recommend against equity plans that contain plan features that ISS deems to have a significant negative impact on shareholder interests. Examples include tax gross-ups related to plan awards and reload option provisions.
Equity Plan Scorecard (EPSC) Evaluations – *Adjusted Factor Weightings*	• While the number of EPSC points needed to receive a "For" recommendation has not changed (55 points for S&P 500 companies, 53 points for all others) certain factor scores have been adjusted. Among the disclosed adjustments, weighting on the plan duration factor has increased to encourage plan resubmission to shareholders more often than required by listing exchanges or under prior IRC Section 162(m) performance-based compensation tax deductibility rules. ➢ To receive full points for plan duration, proposed share reserve should last five years or less (estimate based on company's three-year average burn rate as calculated by ISS). • Maximum points under the Plan Features pillar has been reduced, with a corresponding positive adjustment in the Grant Practices pillar, likely due to the increased weighting of the plan duration factor. See Appendix A for updated maximum scoring by EPSC model and pillar.
Updated Burn Rate Tables	• ISS issued updated burn rate benchmarks for S&P 500, Russell 3000 (non-S&P), and Non-Russell 3000 companies. See Appendix B for details.

ISS Policy Item	2019 Policy Update
IRC Section 162(m)-Related Equity Plan Amendments	• Proposals that only seek approval to ensure tax deductibility of awards pursuant to Section 162(m), now under the "grandfather rule," and that do not seek additional shares for grants or approval of any plan amendments, will generally receive a favorable recommendation regardless of EPSC factors, provided that the board's compensation committee is 100% independent according to ISS standards. ➢ While we don't anticipate this approach to be widespread, it is possible that a company located in a state where Section 162(m) has not been repealed yet (e.g., California), may pursue approval of the plan in order to safeguard Section 162(m) deductibility at the state tax level. • Plan amendments that involve removal of general references to 162(m) qualification will be viewed as neutral. This includes references to approved metrics for use in performance plan-based awards. ➢ ISS encourages companies to maintain plan provisions that represent good governance practices, even if they are no longer required under Section 162(m). • If a plan contains provisions representing good governance practices, even if no longer required under the revised Section 162(m), their removal may be viewed as a negative change in a plan amendment evaluation. ISS provides the example of removing individual award limits as a plan modification that would be viewed negatively.

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Full details regarding ISS' 2019 policy updates and FAQs can be found here.

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<u>**Appendix A**</u>

Maximum Scores by EPSC Model and Pillars

(Source: ISS U.S. Equity Compensation Plans FAQs)

Pillar	Model	Maximum Pillar Score 2019	2018	Comments
Plan Cost	S&P 500, Russell 3000, Non-Russell 3000	45	45	All models include the same Plan Cost factors
	Special Cases – Russell 3000 / S&P 500*	50	50	
	Special Cases – Non-Russell 3000*	60	60	
Plan Features	S&P 500, Russell 3000	**17**	19	All models include the same Plan Features factors
	Non-Russell 3000	**27**	30	
	Special Cases – Russell 3000 / S&P 500*	33	33	
	Special Cases – Non-Russell 3000*	40	40	
Grant Practices	S&P 500, Russell 3000	**38**	36	The Non-Russell 3000 model includes only Burn Rate and Duration factors. The Special Cases model for Russell 3000 and S&P 500 companies includes all Grant Practices factors except Burn Rate and Duration. The Special Cases model for Non-Russell 3000 companies does not include any Grant Practices factors.
	Non-Russell 3000	**28**	25	
	Special Cases – Russell 3000 / S&P 500*	17	17	
	Special Cases – Non-Russell 3000*	0	0	

* Generally covers companies that recently had their IPO, were spun off, or emerged from bankruptcy that do not disclose three years of grant data.

Appendix B

Updated Burn Rate Tables

(Source: ISS U.S. Equity Compensation Plans FAQs)

S&P 500					
GICS	Description	Mean	Standard Deviation	Burn Rate Benchmark*	
10	Energy	1.10%	0.55%	2.00%	*
15	Materials	1.09%	0.66%	2.00%	*
20	Industrials	1.28%	0.76%	2.04%	
25	Consumer Discretionary	1.57%	1.13%	2.70%	
30	Consumer Staples	1.08%	0.59%	2.00%	*
35	Health Care	1.69%	0.79%	2.48%	
40	Financials	1.78%	1.26%	3.04%	
45	Information Technology	2.99%	1.59%	4.58%	
50	Communication Services	1.50%	1.91%	3.41%	
55	Utilities	0.65%	0.33%	2.00%	*
60	Real Estate	2.16%	0.72%	2.88%	

Russell 3000 (excluding the S&P 500)					
GICS	Description	Mean	Standard Deviation	Burn Rate Benchmark*	
1010	Energy	2.39%	1.60%	3.99%	
1510	Materials	1.69%	1.03%	2.72%	
2010	Capital Goods	2.07%	1.68%	3.75%	
2020	Commercial & Professional Services	2.39%	1.40%	3.80%	
2030	Transportation	1.85%	1.54%	3.39%	
2510	Automobiles & Components	1.95%	1.05%	3.00%	
2520	Consumer Durables & Apparel	2.31%	1.50%	3.81%	
2530	Consumer Services	2.88%	2.52%	5.41%	
2550	Retailing	3.21%	2.92%	6.13%	
3010	Food & Retailing Staples	1.95%	1.07%	3.03%	
3020	Food, Beverage & Tobacco	1.56%	0.82%	2.38%	
3030	Household & Personal Goods	2.39%	1.74%	4.13%	
3510	Health Care Equipment & Services	3.91%	2.56%	6.48%	
3520	Pharmaceuticals & Biotechnology	4.66%	2.31%	6.98%	
4010	Banks	1.57%	1.25%	2.81%	
4020	Diversified Financials	4.15%	4.43%	8.58%	
4030	Insurance	1.89%	2.36%	4.26%	
4510	Software & Services	5.75%	3.60%	9.35%	
4520	Technology Hardware & Equipment	3.88%	2.53%	6.41%	
4530	Semiconductor Equipment	4.49%	2.11%	6.61%	
5010	Telecommunication Services	4.46%	5.52%	9.10%	*
5020	Media & Entertainment	3.99%	3.41%	7.40%	
5510	Utilities	1.08%	1.35%	2.43%	
6010	Real Estate	1.29%	1.29%	2.58%	

* The benchmark is generally the Mean + Standard Deviation, subject to minimum benchmark of 2%. In addition, year-over-year burn-rate benchmark changes are limited to a maximum of two (2) percentage points plus or minus the prior year's burn-rate benchmark.

Appendix B (continued)

Updated Burn Rate Tables

(Source: ISS U.S. Equity Compensation Plans FAQs)

Non-Russell 3000					
GICS	Description	Mean	Standard Deviation	Burn Rate Benchmark*	
1010	Energy	2.88%	1.67%	4.55%	
1510	Materials	2.90%	2.33%	5.23%	
2010	Capital Goods	3.30%	3.03%	6.33%	
2020	Commercial & Professional Services	4.69%	4.37%	9.06%	
2030	Transportation	2.31%	1.44%	4.51%	*
2510	Automobiles & Components	3.11%	2.47%	5.58%	
2520	Consumer Durables & Apparel	2.99%	2.01%	5.00%	
2530	Consumer Services	2.75%	2.14%	4.89%	
2550	Retailing	4.31%	2.55%	6.86%	
3010, 3020, 3030	Consumer Staples	4.96%	4.04%	9.00%	+
3510	Health Care Equipment & Services	5.23%	3.41%	8.63%	
3520	Pharmaceuticals & Biotechnology	6.23%	3.63%	9.86%	
4010, 4020, 4030	Financials	2.41%	2.70%	5.11%	+
4510	Software & Services	5.69%	3.56%	9.24%	
4520	Technology Hardware & Equipment	4.58%	3.29%	7.87%	
4530	Semiconductor Equipment	4.32%	2.31%	6.63%	
5010, 5020	Telecom & Media	4.18%	3.31%	8.08%	*+
5510	Utilities	1.59%	1.18%	2.83%	*
6010	Real Estate	1.50%	1.51%	3.07%	*

* The benchmark is generally the Mean + Standard Deviation, subject to minimum benchmark of 2%. In addition, year-over-year burn-rate benchmark changes are limited to a maximum of two (2) percentage points plus or minus the prior year's burn-rate benchmark.

+ Benchmark based on all companies in the two-digit GICS average due to insufficient number of companies to analyze within the four-digit GICS industry.