ALERT

November 20, 2017

ISS RELEASES POLICY UPDATES FOR 2018 PROXY SEASON

On November 16, ISS released policy updates applicable to public companies with annual shareholder meetings on or after February 1, 2018. The compensation-related policy updates impact say-on-pay proposals in the U.S. and Canada and the re-election of board members in the U.S. In addition, ISS adopted a new U.S. policy regarding shareholder proposals seeking gender pay gap information. Finally, the policy updates do not address the use of "realizable pay" or the CEO pay ratio to evaluate pay-for-performance alignment or excessive compensation practices in 2018.

Compensation – Pay-for-Performance Evaluation (U.S. and Canada)

ISS' current quantitative test for Russell 3000 companies is composed of three components, two relative assessments and one absolute assessment:

- The Relative Degree of Alignment (RDA) component, which compares three-year CEO pay rank to three-year total shareholder return (TSR) rank using ISS' peer group for a company;
- The Multiple of Median (MOM) component, which compares one-year CEO pay to the one-year median CEO pay for ISS' peer group for a company; and
- The Pay-TSR Alignment (PTA) component, which looks at five-year CEO pay trend for a company compared to its five-year TSR trend.

For 2017, ISS adopted the Relative Pay and Financial Performance Assessment as a qualitative evaluation to supplement its quantitative test. The assessment compared three-year CEO pay rank to three-year financial performance rank using ISS' peer group for a company like the RDA component. Financial performance was evaluated using six financial metrics plus TSR. The financial metrics were: return on invested capital, return on assets, return on equity, revenue growth, EBITDA growth, and cash flow growth. The weighting of each metric varied by industry.

For 2018, ISS adopted a new Relative Financial Performance Assessment as a third relative assessment component under the quantitative test. The new assessment will compare three-year CEO pay rank to three-year financial performance rank using ISS' peer group. Financial performance will be evaluated using three or four metrics (down from six) with the metrics varying by industry. According to ISS, additional detail regarding the updated methodology will be provided in its pay-for-performance mechanics white paper (typically released in December).

Compensation and Director Re-election – Compensation Committee Communication and Responsiveness (U.S.)

When a company has a low Say-on-Pay vote defined as support of less than 70%, ISS expects the company to engage with major institutional investors to understand their issues with the compensation program. Insufficient responsiveness may result in negative ISS vote recommendations on compensation-related items and/or re-election of Compensation Committee members. The updated policy clarifies the specific information ISS will be looking for in disclosures of engagement efforts for evaluating a compensation committee's responsiveness to shareholders, including:

- Timing and frequency of engagements;
- Participation of independent directors;
- Specific concerns raised by dissenting shareholders; and
- Specific and meaningful actions taken to address shareholder concerns.

Director Re-election – Problematic Compensation Practices (U.S.)

When a company does not have an annual Say-on-Pay vote for expressing concern regarding the compensation of named executive officers, ISS will recommend against or withhold from the members of the compensation committee and potentially the full board if certain issues are present (e.g., significant misalignment between CEO pay and company performance, significant problematic pay practices, and poor communication and responsiveness to shareholders). This policy has been updated to include the following two issues:

- The company fails to include a Say-on-Pay vote when required under SEC provisions or under the company's declared frequency of Say-on-Pay; and
- The company fails to include a Frequency of Say-on-Pay vote when required under SEC provisions.

Problematic Non-Employee Director Compensation Practices

Also, as previously disclosed in October when released for comment, ISS has expanded its problematic compensation practices to include excessive non-employee director compensation. ISS will vote against members of the board committee responsible for approving director compensation if there is pattern of awarding excessive compensation without a compelling rationale or other mitigating factors. A "pattern" is defined as two or more <u>consecutive</u> years, which means the first negative vote recommendations could not be made until the 2019 proxy season.

Problematic Pledging of Company Stock

Lastly, ISS has adopted a separate policy under which it will vote against members of the board committee responsible for overseeing risks related to pledging, or the full board, if a significant level of pledged shares by an executive or director raises concern. Factors to be considered include:

- The presence of a proxy-disclosed anti-pledging policy that prohibits future pledging activity;

- The magnitude of aggregate pledged shares in terms of total common shares outstanding, market value, and trading volume;
- Disclosure of progress or lack of progress in reducing the magnitude of aggregate pledged shares over time;
- Disclosure in the proxy statement that shares subject to stock ownership and holding requirements do not include pledged company stock; and
- Any other relevant factors.

Social and Environmental – Gender Pay Gap (U.S.)

As previously disclosed in October when released for comment, ISS has adopted a new policy on shareholder proposals requesting information on gender pay gaps. Under the new policy, ISS will consider shareholder proposals for reports on a company's pay data by gender, or a report on a company's policies and goals to reduce any gender pay gap, on a case-by-case basis considering the following:

- The company's current policies and disclosure related to both its diversity and inclusion policies and practices;
- The company's compensation philosophy and fair and equitable compensation practices;
- Whether the company has been the subject of recent controversy, litigation, or regulatory actions related to gender pay gap issues; and
- Whether the company's reporting regarding gender pay gap policies or initiatives is lagging its peers.

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ISS' policy updates do not address the use of outcomes-based compensation (i.e., "realizable pay") or the CEO pay ratio in its executive compensation evaluation in 2018. ISS sought input from the marketplace on the use of both items during its policy formulation process this year.[1]

In addition to the pay-for-performance mechanics white paper, ISS is expected to release updated executive compensation policy and equity compensation plan FAQs in mid-December, which will include new burn rate thresholds for 2018 and other executive compensation policy details. Full details regarding ISS' 2018 policy updates can be found here.

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[1] See FW Cook blog dated August 3, 2017.