ALERT

November 27, 2018

ISS RELEASES 2019 VOTING POLICY UPDATES AND PRELIMINARY FAQs

On November 19, ISS released policy updates applicable to public companies with annual shareholder meetings on or after February 1, 2019, and on November 21 preliminary Frequently Asked Questions (FAQs) were released. The compensation-related policy updates impact say-on-pay proposals in the U.S. and Canada. The policy updates confirm ISS will not be introducing Economic Value Added (EVA) performance factors to the 2019 quantitative pay-for-performance test; however, EVA metrics will be featured in ISS' research reports on a phased-in basis for informational purposes. The FAQs confirm no changes to the screens in the quantitative pay-for-performance test components, introduce a new "overriding" factor for equity plan evaluations, and indicate that ISS' policy on director pay evaluations will be revised, with no adverse vote recommendations issued until 2020.

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

ISS' current quantitative test for Russell 3000 companies comprises four components, three 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;
- The Pay-TSR Alignment (PTA) component, which looks at five-year CEO pay trend for a company compared to its five-year TSR trend; and
- The Relative Financial Performance Assessment (FPA), which compares three-year CEO pay rank to three-year financial performance rank (e.g., return on invested capital, return on equity, return on assets, EBITDA growth, growth in cash flow from operations).

Earlier this year, ISS released its annual policy survey to solicit market feedback on the potential use of EVA metrics in lieu of, or in addition to, the existing financial metrics. After assessing the use of EVA metrics, ISS announced no change to its FPA methodology for 2019. ISS will include EVA metrics in its research reports on a phased-in basis over 2019 and will continue to explore the potential for future use of EVA in its FPA assessment in the future.

ISS continues to explore alternatives to the current model that has historically emphasized TSR as the predominant measure of performance. It is interesting to note that ISS elected to explore EVA metrics as opposed to placing more prominence on the new financial metrics ISS adopted in 2018. We suspect many investors and issuers will applaud a more calculated advance as opposed to a rushed foray into EVA metrics, which are generally based on sound financial principles but can be mired with complex adjustments. FW Cook's 2018 Top 250 Report suggests that none of the largest 250 companies in the S&P 500 use EVA metrics in its long-term performance-based incentive plan due, in part, to the complexities associated with these measures.

Director Pay Evaluation – Excessive Non-Employee Director Compensation (U.S.)

In 2018, ISS adopted a policy that could result in adverse vote recommendations for directors responsible for approving/setting non-employee director compensation when there is a recurring pattern (two or more consecutive years) of excessive pay magnitude without a compelling rationale or other clearly explained mitigating factors.

Under this policy, ISS could have begun recommending adverse vote recommendations on director elections beginning in the 2019 proxy season; however, ISS is re-evaluating its methodology used to identifying pay outliers and will postpone adverse director recommendations under this policy until 2020. More details on the revised methodology are expected in the comprehensive FAQs to be released in mid-December.

Increased ISS transparency will be welcomed by investors and issuers, particularly those companies that were identified as having high director compensation in their 2018 ISS research reports. To date, ISS has provided limited guidance ("pay figures above the top 5% of comparable directors") as to the quantum of pay that is deemed excessive, have not clearly defined "comparable" directors, and have not identified mitigating factors (i.e., pay for non-executive chairman of the board, pay for special committees requiring extraordinary time and service such as M&A-related committees or CEO search committees, etc.).

Equity Plan Scorecard (U.S.)

ISS indicated that the passing scores for all U.S. Equity Plan Scorecard (EPSC) models will remain the same as in effect for the 2018 season, subject to ISS' customary weighting/point reallocation among some of the individual factors within each EPSC model. They also revealed two EPSC methodology updates for 2019, but noted that this was not an exhaustive list and the comprehensive FAQs published in mid-December may include further updates.

- **New "Overriding" Factor – Excessive Dilution.** This factor, which applies to S&P 500 and Russell 3000 EPSC models only, will be triggered when the company's equity compensation program is estimated to dilute shareholders' holdings by more than 20% (S&P 500 model) or 25% (Russell 3000 model).

  This change is intended to address shareholder concerns around highly dilutive equity compensation programs. ISS will measure share capital dilution as: (A + B + C) ÷ common shares outstanding, where:

A = number of new shares requested; B = number of shares that remain available for issuance; C = number of unexercised/unvested outstanding awards. This calculation differs from ISS' voting power dilution (VPD), which measures overhang on a fully diluted basis (sum of A, B and C also appears in the denominator). VPD has historically been presented in ISS reports for informational purposes but was not a formal part of ISS' benchmark equity plan policy.

The new overriding factor 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 reserves the right to recommend against equity plans including any plan features that ISS deems to have a significant negative impact on shareholder interests.

- **Change-in-Control (CIC) Vesting Factor.** In 2019, full points for the CIC vesting factor will only be earned if the equity plan clearly specifies vesting treatment for time-based and performance-based awards. The disclosure around CIC vesting provisions, rather than the actual vesting treatment of awards determines EPSC scoring. No points will be earned if the plan is silent on CIC vesting treatment for either type of award, or if the plan provides for discretionary vesting for either type of award.

Glass Lewis 2019 Voting Policy Updates

On October 24, Glass Lewis released U.S. voting policy updates for 2019. Glass Lewis issued several key policy changes focused on executive compensation that impact its vote recommendations on Say-on-Pay and reelection of Compensation Committee members. These policy changes focused on contractual payments and arrangements, front-loaded incentive awards, change in control excise tax gross-ups, recoupment provisions ("clawbacks"), executive compensation disclosures for smaller reporting companies, and other executive compensation clarifications.

For additional details, the recent FW Cook Alert Letter on Glass Lewis 2019 Voting Policy Updates can be found here.

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