

Client Alert

ISS Releases Preliminary U.S. Compensation FAQs for 2018

EXEQUITY

Independent Board and
Management Advisors

On November 21, 2017, ISS released preliminary U.S. Compensation FAQs for 2018 that cover the Quantitative Pay-for-Performance (P4P) tests and the Equity Plan Scorecard (EPSC) policy.¹ These **FAQs make some significant changes** to the existing ISS policies and it appears that they will apply to shareholder meetings on and after February 1, 2018, even though they were not released as part of ISS's Policy Updates for 2018. ISS has indicated that commonly received questions on these policies and other changes could be included in the final set of FAQs.

First, with respect to the **Quantitative P4P tests**:

- ISS is dropping the **medium concern threshold** for the **Multiple of Median (MOM)** test from **2.33x to 2.00x for S&P 500 companies** covered by ISS's U.S. Policies. All other thresholds remain the same for 2018.
- **Total Shareholder Return** will now be calculated using a “**smoothing**” method by ISS for both the beginning-of-period and end-of-period stock prices by **averaging** the beginning and ending **stock price for the month** closest to the fiscal year-end of a company. Stock splits and dividends occurring during such averaging periods will be factored into the TSR calculations. If a company's fiscal year-end is on/after the 15th of the month, then that monthly stock price average will be used; otherwise, the monthly average of the prior month will be used.
- **Financial Performance Assessment (FPA)** will be applied as a secondary measure after the traditional three quantitative tests (MOM, Relative Degree of Alignment (RDA), and Pay-TSR Alignment (PTA)) are calculated. The preliminary FAQs do not indicate how FPA is calculated. FPA will then be used to assess how well companies performed on relative financial metrics and may cause ISS to score the overall quantitative P4P concern level differently than the traditional quantitative P4P tests' concern level. The preliminary FAQs give the following examples FPA could cause: (1) an overall quantitative P4P concern to register as **low concern** when the traditional quantitative tests indicate a **medium concern**, and (2) ISS to score the overall quantitative P4P concern as **medium concern** when the traditional quantitative tests indicate a **low concern**.
- The Preliminary FAQs include a chart showing which financial metrics for the various GICS groups (see Appendix to this Client Alert) will be used in calculating FPA—no word on the weightings of these metrics is provided.

¹ The ISS preliminary U.S. Compensation FAQs can be found at: <https://www.issgovernance.com/policy-gateway/latest-policies/>.

Exequity Comment: Lowering of the medium concern threshold for the MOM test to 2.00 may catch some companies in 2018. Hopefully, the “smoothing” of TSR and introduction of FPA as a secondary screen will help provide an offset. We will have to wait until ISS releases its white paper on pay-for-performance methodology to see if it addresses the weighting of the various financial metrics included in FPA.

Second, with respect to **EPSC Policy**, ISS appears to be making a couple of **significant** changes:

- The **minimum points** necessary to pass the EPSC model is being increased from 53 points to **55 points** for all **S&P 500 companies**; for all other companies, the minimum point requirement remains at 53 points.

- **Change in Control Vesting Factor** under the EPSC will now only result in full or no points. Full points will be awarded when an equity plan contains **both** of the following provisions:

— For **performance-based awards**, acceleration is limited to actual performance achieved, pro rata of target based on the elapsed portion of the performance period, a combination of both actual and pro rata, or the performance awards are forfeited or terminated upon a change in control (CIC). If no performance awards exist, points for this factor will be based solely on the treatment of time-based awards.

— For **time-based awards**, acceleration upon a CIC cannot be automatic single trigger or discretionary.

Any other provision for CIC treatment results in no points under this factor.

- **Holding Requirements Factor** is being “simplified” for 2018 and ISS will either award full or no points. To receive full points, awards must be subject to a minimum 12-month holding period, or a required hold through the end of employment. A holding period of less than 12 months or only until stock ownership guidelines are met will result in no points under this factor.
- **CEO Vesting Requirement Factor** is also being “simplified” for 2018 and there will either be full or no points under this factor. To receive full points, time-based options, time-based restricted stock, and performance-based equity compensation for the CEO must all have a vesting requirement of at least three years from the date of grant until all shares under the award vest.
- **Broad Discretion to Accelerate Vesting Factor** is being revised so that full credit under this factor will only be awarded if the discretion to accelerate vesting is limited to cases of death and disability. If discretion extends to CIC, retirement, or other terminations, the plan would not receive any points under this factor.

Exequity Comment: Up to this point, we have generally advised clients **not** to comply with the requirements of the Broad Discretion to Accelerate Vesting factor since it unnecessarily tied the hands of a company to accelerate vesting in situations where it would be appropriate (e.g., retirement, reductions in force, etc.). Therefore, we do not think this change will cause an issue for most companies as they generally were not receiving points for this factor under the prior EPSC policy. The change to the CEO Vesting Requirement Factor is likely to benefit many companies. But, the other changes laid out above will impact provisions included in equity plans and/or cause a reduction in the number of shares that plans

can request and pass the EPSC model. ISS Corporate Solutions has indicated to Exequity that it expects to have the online EPSC model updated to reflect the preliminary FAQ changes on December 1 and shortly afterwards to be updated for the December 1 quarterly data download date. Keep in mind the final set of comprehensive FAQs could contain other changes to ISS's EPSC policy and Quantitative P4P tests. The changes described in the preliminary U.S. Compensation FAQs merely reflect the most common questions received by ISS; the final FAQs could be different as well as contain other changes to ISS's compensation policies.



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Appendix

The table below is from ISS's preliminary U.S. Compensation FAQs released November 21, 2017 and provides the financial metrics that ISS will use for each of the indicated GICS industry groups when calculating FPA.

GICS-4	Industry	Financial Metrics			
		Rank 1	Rank 2	Rank 3	Rank 4
1010	Energy	ROIC	ROA	ROE	EBITDA Growth
1510	Materials	ROA	ROE	EBITDA Growth	ROIC
2010	Capital Goods	ROIC	ROA	ROE	EBITDA Growth
2020	Commercial & Professional Services	ROIC	ROE	ROA	EBITDA Growth
2030	Transportation	ROIC	ROA	ROE	EBITDA Growth
2510	Automobiles & Components	ROIC	ROA	ROE	EBITDA Growth
2520	Consumer Durables & Apparel	ROIC	ROA	ROE	EBITDA Growth
2530	Consumer Services	EBITDA Growth	ROIC	ROA	ROE
2540	Media	ROIC	ROA	ROE	EBITDA Growth
2550	Retailing	ROE	ROIC	ROA	EBITDA Growth
3010	Food & Staples Retailing	ROA	ROIC*	ROE*	EBITDA Growth
3020	Food Beverages & Tobacco	ROA	ROIC*	ROE*	EBITDA Growth
3030	Household & Personal Products	ROA	ROIC*	ROE*	EBITDA Growth
3510	Health Care Equipment & Services	EBITDA Growth	ROIC	ROA	ROE
3520	Pharmaceuticals, Biotechnology & Life Sciences	ROIC	EBITDA Growth	ROA	ROE
4010	Banks	ROA	ROIC*	ROE*	
4020	Diversified Financials	ROIC	ROA*	ROE*	
4030	Insurance	ROIC*	ROA*	Operating Cash Flow Growth	ROE
4510	Software & Services	ROIC	ROA	ROE	EBITDA Growth
4520	Technology Hardware & Equipment	ROIC*	ROA*	ROE**	EBITDA Growth**
4530	Semiconductors & Semiconductor Equipment	ROIC	ROA	ROE	Operating Cash Flow Growth
5010	Telecommunication Services	ROA	ROE	ROIC	EBITDA Growth
5510	Utilities	ROIC	ROA	ROE	EBITDA Growth
6010	Real Estate	ROIC	ROA	ROE	Operating Cash Flow Growth

* Indicates equal weighting for two metrics within an industry. These metrics are listed adjacently in this table.

** For GICS 4520, metrics with rank 1 and 2 are weighted equally, and metrics with rank 3 and 4 are also weighted equally but less than the rank 1 and 2 metrics.