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Client Alert

ISS Issues Final FAQs and Updated Documents for the 2018 Proxy Season

EXEQUITY

Independent Board and Management Advisors

On December 14, 2017, ISS issued several important updated documents concerning its policies and methodologies for the upcoming 2018 Proxy Season:[1]

- U.S. Compensation Policies, Frequently Asked Questions;
- U.S. Equity Compensation Plans, Frequently Asked Questions; and
- Pay-for-Performance Mechanics, ISS' Quantitative and Qualitative Approach (U.S.).

These updated FAQs and documents generally apply to shareholder meetings occurring on or after February 1, 2018.

In addition, in its newsletter released January 12, 2018, the Head of U.S. Compensation Research at ISS, David Kokell, provided insight into how ISS will assess potential changes in compensation practices as a result of the enactment of The Tax Cuts and Jobs Act of 2017.[2] While ISS noted Mr. Kokell's insight does not constitute official ISS policy, it does give a glimpse into how ISS may view actions companies take in response to the tax law changes.

U.S. Compensation Policies: FAQs

This set of newly issued FAQs supersedes the preliminary FAQs issued in November 2017. The updated FAQs:

- Explain how ISS assesses a board's actions taken in response to low support (<70%) on a say-on-pay (SOP) vote.
  - Same as last year's policy, except ISS now expects companies to address the following in their proxy statements:
    - The breadth of the engagement with shareholders, including the frequency and timing of engagements, number of institutional investors and company participants, including whether independent directors participated as well;
    - Disclosure of specific feedback received from investors; and
    - Specific and meaningful actions taken to address shareholder concerns.

[1] These documents are all available on ISS' Latest Voting Policies: 2018 webpage: https://www.issgovernance.com/policy-gateway/voting-policies/.

[2] U.S. Tax Reform: Changes to 162(m) and Implications for Investors, ISS Corporate Solutions' *Governance Insights*, January 12, 2018.

- Lay out the four measures ISS now uses in its quantitative pay-for-performance (P4P) screen:
  - Relative Degree of Alignment (RDA)—existing relative measure;
  - Multiple of Median (MOM)—existing relative measure;
  - Pay-TSR Alignment (PTA)—existing absolute measure; and
  - Financial Performance Assessment (FPA)—new relative measure—assesses CEO pay rank and financial performance rank over a two- or three-year period using up to four financial metrics which vary by industry.
- Explain how the new FPA measure operates.
  - Compares a company's financial and operational performance over the long term versus the ISS peer group.

    Exequity Comment: *ISS has historically taken the position, in the context of performance-based equity awards, that "long term" requires a performance period of at least three years.*
  - FPA uses three or four financial metrics that are selected and weighted based on industry.
  - The financial metrics that could be used include return on invested capital (ROIC), return on assets (ROA), return on equity (ROE), EBITDA growth, and cash flow (from operations) growth.
- Explain the impact the FPA will have on the overall quantitative P4P concern level ISS determines.
  - FPA may affect the overall quantitative P4P concern level (and increase or decrease such concern) only if:
    - A Medium concern is shown under any of the three initial tests (RDA, MOM, or PTA); or
    - A Low concern is shown but it borders on Medium concern threshold, i.e., "Low Bordering Medium," under any of the three initial tests.
  - FPA can modify the overall concern to increase it up to Medium concern or decrease it to Low concern.
  - If the concern level under any of the three initial tests is a High concern or the three initial tests result in a Low concern not bordering Medium concern, then no FPA modification of the concern level will occur.
- Explain the time period and methodology ISS will use for calculating TSR for the RDA.
  - ISS uses a three-year period for measuring TSR ending closest to the fiscal year-end of the subject company.
  - TSR for the subject company and the ISS peers will be measured over that period.
  - ISS will average the closing stock prices across all trading days contained in the beginning and ending months of the TSR measurement period (ISS previously used the stock price on the beginning and end dates of the TSR measurement period).

- Explain which problematic pay practices are most likely to result in an adverse ISS vote recommendation.
  - Repricing or replacing underwater stock options/SARs (stock appreciation rights) without prior shareholder approval (including cash-outs).
  - Extraordinary perquisites or tax gross-ups.
  - New or extended executive agreements that provide for:
    - Excessive change-in-control (CIC) payments (exceeding three times base salary and average/target/most recent bonus);
    - CIC severance payments without involuntary job loss or substantial diminution of duties;
    - CIC payments with excise tax gross-ups;
    - Multi-year guaranteed awards that are not at-risk due to rigorous performance conditions; or
    - Liberal CIC definition combined with any single-trigger CIC benefits.
  - Any other provision or practice deemed to be egregious and present a significant risk to investors.
- Explain how ISS will identify “excessive” levels of non-employee director (NED) pay and the impact this might have on ISS’ analysis.
  - ISS is looking for extreme “outliers” in NED pay, which historically have represented pay figures above the top 5% of all comparable directors.
  - If ISS finds excessive NED pay levels to exist, it may issue adverse vote recommendations for those board members responsible for approving/setting NED pay if no compelling rationale is provided.
- Explain how ISS will consider the new CEO Pay Ratio disclosure.
  - In its research reports, ISS will display the median employee pay figure and the CEO Pay Ratio.
  - ISS will continue to assess the CEO Pay Ratio data as it becomes available and seek feedback from investors on the usefulness of this information and what should be done with it.

U.S. Equity Compensation Plans: FAQs

This set of newly issued FAQs supersedes the preliminary FAQs issued in November 2017 regarding ISS’ Equity Plan Scorecard (EPSC) policy. The updated FAQs:

- Lay out the changes to the EPSC policy for the 2018 proxy season:
  - Passing score for S&P 500 companies increased to 55 points (from 53 points).
  - The CIC vesting factor was made binary—either full or no points are earned, depending on whether the plan complies with the ISS CIC vesting requirements:
    - For performance-based awards: acceleration of vesting 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 CIC; **and**
    - For time-based awards: acceleration of vesting cannot be automatic single-trigger or discretionary.

- The holding requirement factor was made binary—either full or no points are earned, depending on whether all awards require a holding period of at least 12 months. No points are given if the holding period is less than 12 months, or the holding requirement applies only until stock ownership guidelines are met.
- The CEO vesting requirement factors were made binary—either full or no points are earned depending on whether the vesting period is at least three years from the date of grant.
- The broad discretion to accelerate vesting factor was updated so that full points are now only earned if such discretion is limited to cases of death and disability. Discretion to accelerate vesting upon a CIC will cause no points to be awarded under this factor—a change from past policy. The ability to use discretion to accelerate vesting in any other situation would cause the plan to lose points under this factor.
- ISS adjusted certain factor scores, per ISS' proprietary scoring model.

- Explain how the EPSC model now differs by company group.
  - S&P 500 companies: must now score at least 55 points to pass the model.
  - All other companies: continue to only require a score of at least 53 points to pass the model.
- Revise the allocation of points for Russell 3000 and S&P 500 companies among the three pillars of the EPSC model so that the Plan Features pillar has a maximum of 19 points and the Grant Practices pillar has a maximum of 36 points (compared to 20 points and 35 points, respectively, previously), while the Plan Cost pillar continues to have a maximum of 45 points.
- Lay out when repricing provisions will constitute an overriding factor that would cause ISS to recommend against a plan proposal regardless of what it scores under the EPSC model.
- Explain that a plan will only meet the minimum vesting requirement if it mandates a vesting period of at least one year for all equity awards grantable, which applies to no less than 95% of the plan's share authorization. If the plan permits individual award agreements or other mechanisms to reduce or eliminate the minimum vesting requirement, the plan receives no points under this factor.
- Explain how ISS will treat the grant of time-vested restricted shares as consideration for an acquisition for purposes of its burn rate calculation.
  - Generally, ISS will factor all equity grants into its burn rate calculation. However, if a company grants time-vested restricted shares as part of an acquisition, it may request that such shares be excluded from the ISS burn rate calculation. But, the company must provide tabular disclosure to enable ISS to determine the shares used in each of the three most recent years. The FAQs provide a sample of the table that must be provided. This disclosure must continue to be provided thereafter, even if the company did not issue any time-vested restricted shares for acquisitions in the most recent year. Performance-based awards issued in an acquisition context will continue to be included in ISS' burn rate calculation.
- Confirm that all previous ISS burn rate commitments are now dead and of no force, and that ISS no longer gives any special treatment to companies that made or make a burn rate commitment.

- Lay out the definition of "liberal change in control" and its impact on a plan that contains such term.
  - Means vesting triggers are linked to: shareholder approval of the transaction, rather than its consummation; and/or an unapproved change in less than a majority of the board; and/or acquisition of a low percentage of outstanding common stock (15% or less); and/or announcement or commencement of a tender offer or exchange offer; or any other trigger that could result in windfall compensation without the occurrence of an actual CIC of the company.
- Explain how ISS evaluates an equity plan proposal seeking approval of one or more amendments.
  - Evaluated on a case-by-case basis.
  - ISS will generally base its vote recommendation on the EPSC evaluation/score if any of the following apply:
    - The proposal includes a material request for additional shares;
    - The proposal represents the first time shareholders have had an opportunity to vote on the plan;
    - The amendments include an extension of the plan's term; or
    - The amendments include the addition of full value awards as an award type when the current plan authorizes only stock option/SAR grants.
  - If none of the four scenarios above apply, then ISS' vote recommendation will depend on the overall impact of the proposed amendments, i.e., whether deemed beneficial or contrary to shareholders' interests.
- Explain the factors that ISS considers in its qualitative review of director pay for the purpose of a proposal seeking approval of a director equity plan.
  - The relative magnitude of director compensation compared to companies of a similar profile.
  - The presence of problematic pay practices relating to director compensation.
  - Director stock ownership guidelines and holding requirements.
  - Equity award vesting schedules.
  - The mix of cash and equity-based compensation.
  - Meaningful limits on director compensation.
  - The availability of retirement benefits or perquisites.
  - The quality of disclosure surrounding director compensation.
- Explain if a company does not provide a copy of an equity plan amendment that is being put to shareholders for approval, ISS may recommend against the proposal.
- Include the 2018 Burn Rate Benchmarks (see the Appendix to this Client Alert).

***Exequity Comment**: These changes to the EPSC policy are significant and will impact all companies taking equity plan proposals to shareholders, particularly S&P 500 companies. But even for non-S&P 500 companies, these changes are likely to impact the structure of their new equity plans, the number of shares that will "pass" the ISS EPSC model, or both. ISS has, in effect, more narrowly defined equity plan practices it finds acceptable and for which it is willing to provide points under the ISS EPSC model. This will further undercut the flexibility of equity plans designed to garner maximum points under the ISS EPSC model. In essence, without modifications to plan terms, a smaller request of shares will be required to pass the ISS EPSC model, likely resulting in companies having to seek shareholder approval of a plan more frequently.*

Pay-for-Performance Mechanics (U.S.)

The document does not go into great detail about how ISS runs its P4P analysis. ISS does provide a general overview of the tests it uses, but does not give sufficient detail for a company to be able to fully understand the ISS P4P analysis.

The document lays out a change for concern thresholds for S&P 500 companies on the MOM test. Now, the threshold for a Medium concern for such companies will be 2.00x, whereas it had been 2.33x. For all other companies, the Medium concern threshold remains at 2.33x.

The tables below lay out the concern thresholds for the three quantitative tests and the concern levels for which FPA modification is possible. ISS will produce two concern results: (1) an "Initial Quantitative Concern" level, which is determined by the results of the three primary quantitative tests—RDA, MOM, and PTA; and (2) an "Overall Quantitative Concern" level, which reflects the concern level from the initial quantitative screen, which may or may not be impacted by the FPA results. The Overall Quantitative Concern will be the indicator of any P4P disconnect warranting an in-depth qualitative evaluation.

ISS noted most companies will not have their Overall Quantitative Concern level modified by the FPA result. As stated, the FPA adjustment may have an impact only if a company has a Medium or Low Bordering Medium concern level under the initial quantitative screen. The FPA result will not impact the Overall Quantitative Concern level for companies with a High concern level or a Low concern level, provided all three initial quantitative tests are below the Low Bordering Medium threshold, as indicated below.

S&P 500 Companies' Concern Level Thresholds

	Low	Low Bordering Medium (FPA Modification)	Medium (FPA Modification)	High
RDA	<-28.4	-28.4	-40	-50
MOM	<1.64x	1.64x	2.00x	3.33x
PTA	<-13%	-13%	-20%	-35%

Non-S&P 500 Companies' Concern Level Thresholds

	Low	Low Bordering Medium (FPA Modification)	Medium (FPA Modification)	High
RDA	<-28.4	-28.4	-40	-50
MOM	<1.74x	1.74x	2.33x	3.33x
PTA	<-13%	-13%	-20%	-35%

Finally, this document lays out the metrics that will be used for the FPA for each GICS group, but does not specify the weighting.

GICS-4	Industry	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 Beverage & 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	EBITA Growth	ROA	ROE
4010	Banks	ROA	ROIC*	ROE*	
4020	Diversified Financials	ROIC	ROA*	ROE*	
4030	Insurance	ROIC*	ROA*	Operating Cash Flow	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.

***Note**: In the case of material merger or spin-off activity during the financial assessment measurement period, the analysis will exclude EBITDA Growth or Cash Flow Growth for the quarterly periods impacted by the corporate action. The affected metric will still be used if sufficient data exists following the merger or spin-off activity so that ISS can calculate a minimum two-year measurement period (through the calculation date), excluding the impacted quarters. However, if a metric is excluded from the assessment, the original weight that was assigned to the excluded metric will be redistributed proportionately to the remaining valid metrics. Capital productivity measures (ROIC, ROA, and ROE) will not be excluded in these situations, as these metrics are generally more consistent and should reflect the impact of the corporate action.*

***Exequity Comment**: ISS has effectively introduced a new concern range into the quantitative P4P analysis—it remains to be seen what impact this change and the introduction of the FPA adjustment will have on ISS' SOP vote recommendations. We do not believe these will have a significant impact for most companies. However, for companies that are at the Low Bordering Medium concern level, it could have a significant impact. Companies facing a Medium or Low Bordering Medium concern level on any of the initial quantitative P4P tests should review their relative financial performance as well as assess how well their policies, practices, and actions comply with what ISS views as best practices. If not fully following key best practices, such companies should consider whether they can implement any changes prior to filing their proxy, with the expectation that such change would be highlighted in the new proxy. Doing so may help such companies when ISS conducts its qualitative P4P analysis and make it less likely that ISS would recommend against such companies' SOP votes. Note that in 2017, ISS recommended "AGAINST" the SOP proposal at 12% of companies. And in 2017, if a company had a High quantitative concern level, 51% of companies still received a "FOR" recommendation. 74% of companies with a Medium concern level and 96% of companies with a Low concern level received "FOR" recommendations. Thus, there is some increased risk if the FPA moves a company from a Low concern level to a Medium concern level.*

Mr. Kokell of ISS also indicated that investors will continue to expect executive pay programs to emphasize performance-based incentives—awards that are conditioned on the achievement of rigorous and transparent performance goals. Mr. Kokell concluded the interview with a warning, "we recognize that with the removal of 162(m) comes the potential for companies to remove shareholder risk-reducing plan features. I would caution companies that may be considering removing these shareholder-friendly features (such as limits on discretion or award caps) from their incentive programs simply because they are no longer required under 162(m). ISS, and many investors, will view such actions as detrimental to shareholders' interests. In fact, some investors would prefer to see a move to adopt overall individual award limits (covering all award types in a plan)."[3]

[3] Ibid.

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Appendix: 2018 Burn Rate Benchmarks

S&P 500

GICS	Description	Mean	Standard Deviation	Burn Rate Benchmark*
10	Energy	1.14%	0.54%	2.00%*
15	Materials	1.06%	0.52%	2.00%*
20	Industrials	1.24%	0.68%	2.00%*
25	Consumer Discretionary	1.47%	0.94%	2.40%
30	Consumer Staples	1.18%	0.51%	2.00%*
35	Health Care	1.75%	0.77%	2.52%
40	Financials	1.82%	1.42%	3.24%
45	Information Technology	3.19%	1.65%	4.84%
50	Telecommunication Services	0.91%	0.50%	2.00%*
55	Utilities	0.70%	0.32%	2.00%*
60	Real Estate	0.82%	0.68%	2.00%*

* 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.

Russell 3000 (Excluding the S&P 500)

GICS	Description	Mean	Standard Deviation	Burn Rate Benchmark*
1010	Energy	2.27%	1.47%	3.74%
1510	Materials	1.64%	0.97%	2.61%
2010	Capital Goods	2.00%	1.70%	3.70%
2020	Commercial & Professional Services	2.60%	1.64%	4.24%
2030	Transportation	1.62%	1.04%	2.66%
2510	Automobiles & Components	2.02%	0.97%	3.00%
2520	Consumer Durables & Apparel	2.33%	1.47%	3.80%
2530	Consumer Services	2.76%	2.79%	5.55%
2540	Media	2.18%	1.42%	3.60%
2550	Retailing	2.38%	1.82%	4.20%
3010	Food & Retailing Staples	1.70%	0.95%	2.65%
3020	Food, Beverage & Tobacco	1.57%	081%	2.37%
3030	Household & Personal Goods	3.14%	1.80%	4.93%
3510	Health Care Equipment & Services	3.51%	2.17%	5.69%
3520	Pharmaceuticals & Biotechnology	4.70%	2.38%	7.08%
4010	Banks	1.62%	1.31%	2.93%
4020	Diversified Financials	4.03%	4.60%	8.63%
4030	Insurance	2.01%	2.34%	4.36%
4510	Software & Services	6.35%	3.88%	10.22%
4520	Technology Hardware & Equipment	3.76%	2.40%	6.16%

GICS	Description	Mean	Standard Deviation	Burn Rate Benchmark*
4530	Semiconductor Equipment	4.21%	2.11%	6.32%
5010	Telecommunication Services	3.69%	3.41%	7.10%
5510	Utilities	0.97%	1.12%	2.09%
6010	Real Estate	1.38%	1.45%	2.82%

* 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.

Non-Russell 3000

GICS	Description	Mean	Standard Deviation	Burn Rate Benchmark*
1010	Energy	3.04%	3.00%	6.04%
1510	Materials	2.88%	2.75%	5.62%
2010	Capital Goods	3.40%	2.46%	5.85%
2020	Commercial & Professional Services	5.64%	4.01%	9.40%*
2030	Transportation	4.14%	3.33%	6.51%*+
2510	Automobiles & Components	3.59%	2.95%	6.23%*
2520	Consumer Durables & Apparel	3.10%	2.16%	5.26%
2530	Consumer Services	2.42%	1.75%	4.18%
2540	Media	5.02%	3.69%	8.71%
2550	Retailing	4.39%	2.14%	6.53%
3010, 3020, 3030	Consumer Staples	4.10%	3.47%	7.57%+
3510	Health Care Equipment & Services	5.16%	3.17%	8.33%
3520	Pharmaceuticals & Biotechnology	5.19%	3.53%	8.72%
4010, 4020, 4030	Financials	2.68%	3.02%	5.70%+
4510	Software & Services	5.38%	4.10%	9.48%
4520	Technology Hardware & Equipment	4.51%	3.25%	7.76%
4530	Semiconductor Equipment	4.51%	2.77%	7.27%
5010	Telecommunication Services	6.93%	3.15%	10.08%
5510	Utilities	2.99%	2.77%	4.83%*
6010	Real Estate	2.42%	4.33%	5.07%*

* 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 2-digit GICS average due to insufficient number of companies to analyze within the 4-digit GICS industry.

Source: ISS' U.S. Equity Compensation Plans: Frequently Asked Questions, Updated December 14, 2017.