Director Compensation likely to be Target of ISS 2018 Policy Updates

As it does each fall, Institutional Shareholder Services has published a preview of some of its likely updates to its corporate governance policies for U.S. companies for the 2018 proxy season. Although it is not a comprehensive summary of all of the policy changes that may apply in 2018, the preview highlights a potentially significant item for the Boards of Directors of technology and life sciences companies. Specifically, ISS is considering a policy that would trigger an unfavorable recommendation for the members of Board committees who are responsible for approving/setting non-employee director compensation when there is a pattern (that is, two or more consecutive years) of excessive pay without a compelling rationale or other mitigating factors.

ISS is inviting companies, shareholders, and other market participants to comment on the proposed policy updates before it finalizes the policies for next year. Time to respond is limited, however, as comments must be received by Thursday, November 9, 2017. ISS plans to issue its final 2018 U.S. and International Policy updates during the second half of November.

ISS' updated policies will be effective for annual meetings of shareholders held after February 1, 2018.

Background

As a long-time advisor to the institutional investor community, ISS is considered a bellwether for the key shareholder issues to be addressed each proxy season. ISS regularly publishes annual updates to its standards on good corporate governance and executive compensation policies and practices. These standards, which are contained in a series of policy statements, are used by ISS to formulate the voting recommendations that it provides to its clients for the election of directors and other proposals submitted for shareholder action at annual meetings of shareholders, as well as to analyze companies' corporate governance and executive compensation policies and practices.

On October 26, 2017, as a prelude to the publication of its policy guidelines for 2018, ISS announced that it was soliciting comments on a number of the policy updates under consideration. While the proposed updates do not reflect all of the policies that will apply during the 2018 proxy season, they represent the more significant issues that have been percolating just under the surface for the past couple of years and often portend areas where ISS plans to apply scrutiny going forward. See, for example, our Thoughtful Pay Alert, *Director Compensation Litigation - A Mid-Year Update*. (July 6, 2016).

Director Compensation

Suggesting that compensation for non-employee directors has received increased attention in recent years, ISS notes that its 2017 Board Practices Study indicated that median non-employee director pay at S&P 1500 companies has steadily increased every year since 2012, reaching approximately $211,000 in 2016. Citing a growing interest on the part of investors in both the magnitude of director compensation, as well as the structure of these pay packages, ISS suggests that this attention has contributed to various proxy contests and legal actions challenging director pay, leading many companies to place annual limits on director equity awards or to seek shareholder approval of their director compensation program.

ISS goes on to state that, while the magnitude of director compensation varies by company size and industry, it has identified "some" extreme pay outliers. It also notes that investor respondents to its 2018 Policy Application Survey indicated a strong preference for adverse vote recommendations where a pattern of excessive non-employee director pay has been identified.

The proposed new policy would hold directors accountable when they are determined to have approved "excessive" compensation arrangements for a company's non-employee directors without adequate justification. As proposed, board committee members who are responsible for approving and/or setting non-employee director compensation would receive a "withhold" or "against" recommendation for re-election to the Board of Directors when there is a pattern (that is, two or more consecutive years) of excessive non-employee director pay without a compelling rationale or the presence of other mitigating factors.

Director Compensation likely to be Target of ISS 2018 Policy Updates (continued)

No Immediate Effect in 2018

ISS has indicated that there will be no impact on vote recommendations in 2018 for directors as a result of this proposed new policy. Going forward, however, negative recommendations will be triggered only after a pattern of excessive non-employee director pay is identified in consecutive years.

ISS expects a minimal impact for most Boards of Directors as the policy is focused on extreme director pay outliers.

ISS Soliciting Feedback on Policy Parameters

In its request for comments, ISS is seeking input on three specific issues:

- Under what circumstances would a large non-employee director pay package warrant support on an exceptional basis (for example, in the case of a one-time "onboarding" equity award granted to a new director)?
- If the disclosure in a company's proxy statement does not clearly indicate which board committee is responsible for setting and/or approving non-employee director compensation, which board members should be held accountable?
- In calculating average/median pay, should ISS include outsized pay packages provided to non-employee board chairs, lead directors or other board members who receive outsized director pay?

Observations

While the proposed new policy marks ISS's first significant foray into the area of director compensation, in view of the spotlight in recent years on director pay (particularly the well-publicized litigation on director equity awards) it does not come as a surprise. Either of its own initiative or as the result of client pressure, ISS is considering taking its first tentative steps into evaluating the merits of director compensation programs. At this point, the key question is how it intends to determine whether "excessive" director pay exists. While the commentary accompanying the proposal suggests that the analysis will be framed in terms of relative pay, it remains to be seen whether this will be reflected in its ultimate methodology. The fact that ISS is soliciting input from interested parties indicates that the final answer is still uncertain (as is the question of whether a formal policy will be adopted). In any event, ISS's announcement is another indication that director pay is starting to appear on the radar of some institutional shareholders.

What's Next?

ISS is soliciting comments on its proposed policy updates until Thursday, November 9, 2017. ISS has indicated that it plans to issue its policy updates for 2018 during the second half of November. As in prior years, the policy updates will go into effect at the beginning of February of the following year; in this case, February 1, 2018.

To access the ISS portal to its proposed policy updates, click here.

Need Assistance?

Compensia has extensive experience in assisting companies design and implement compensation programs for their Board of Directors. If you would like assistance in developing or reviewing your director pay practices, or if you have any questions on the subjects addressed in this Thoughtful Pay Alert, please feel free to contact Jason Borrevik at 408.876.4035 or Mark A. Borges at 415.462.2995. ■

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