ISS Issues 2019 Benchmark Policy Updates

Institutional Shareholder Services ("ISS") has announced the updates to its U.S. benchmark voting policy guidelines for 2019. Of the two possible significant policy changes that ISS previewed in October, only one has been adopted for the 2019 proxy season – a new policy that will trigger an unfavorable recommendation for the chair of the Board nominating committee if there is no gender diversity on the Board of Directors. A second possible policy change, which would have replaced GAAP accounting measures in its Financial Performance Assessment screen with economic value added ("EVA") metrics, was not adopted. Instead, ISS will continue to explore the potential for future use of EVA to provide additional insight as part of its financial performance analysis. The updates will be reflected in the corporate governance and executive compensation policies that ISS will use to determine its voting recommendations for its proxy advisory clients during the upcoming 2019 proxy season.

A summary of ISS' benchmark policy changes for 2019 are available at the following link: please click here.

Significance of Policies

As a long-time advisor to the institutional investor community, ISS is the bellwether for the key shareholder issues to be addressed each proxy season. ISS regularly publishes annual updates to its standards on corporate governance and executive compensation policies and practices. The standards for U.S.-based companies, which are contained in a policy statement published in advance of each year's proxy season, are used by ISS to formulate the voting recommendations that it provides to its clients for the election of directors, the "Say-on-Pay" vote, the approval of employee stock plans and other proposals submitted for action at annual meetings of shareholders, as well as to analyze companies' corporate governance and executive compensation policies and practices.

This article summarizes the information currently available from ISS relating to the key executive compensation and corporate governance-related policy updates for 2019. These policies will be effective for annual meetings of shareholders taking place on or after February 1, 2019.

Board Gender Diversity

In recognition of the heightened interest of investors in the composition of corporate boards, during 2018 ISS' research reports began noting where a company's board of directors lacked gender diversity. Citing the presence of at least one female director on a board as the market norm, ISS has now adopted a new voting policy for companies with no female directors serving on their boards.

The new policy, which will be **effective for annual meetings of shareholders on or after February 1, 2020**, will apply to companies in either the Russell 3000 or the S&P 1500 indices. Specifically, following a one-year "grace period" during 2019, an adverse voting recommendation may be issued against the chair of the nominating committee at Boards of Directors with no gender diversity. While the chair of the nominating committee is the primary target of the policy, ISS notes that, on a case-by-case basis, the election of other directors who are responsible for the board nomination process may be impacted.

As adopted, in exceptional circumstances, the policy allows the absence of board gender diversity to be explained and excused. Mitigating factors that may excuse non-compliance include a firm commitment to appoint a female director to the board in the near term, the presence of at least one female director on the board at the immediately preceding annual meeting, and/or any other relevant factors.

Observations. With this new gender diversity policy, ISS joins Glass Lewis & Co., Inc., the other major proxy advisory firm, in addressing public concern over the low number of women on corporate boards. (The Glass Lewis policy goes into effect in 2019, a year earlier than the just-adopted ISS policy.) These developments follow the recent enactment by the State of California of a new law requiring that the boards of directors of publicly-held corporations with their principal executive offices located in the state to have a specified minimum number of female members on their Board of Directors. (See our recent Thoughtful Pay Alert, New California Law Promotes Gender Parity on Corporate Boards of Directors (Oct. 5, 2018)) It is projected that approximately 10%

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of the companies in the Russell 3000 have Boards of Directors without any female members. The policies of ISS and Glass Lewis will now put additional pressure on these companies to rectify this situation in the immediate future.

"Pay-for-Performance" Methodology – Financial Performance Assessment

During the 2018 proxy season, ISS added the Financial Performance Assessment ("FPA") test to the quantitative "screening" portion of its pay-for-performance methodology. Considered a "secondary" screening "modifier" to the pay-for-performance methodology, generally the FPA compares a company's financial and operational performance against its ISS-constructed peer group over a three-year period. Depending on each company's industry sector, the FPA uses either three or four of the following financial metrics to make this comparison:

- Return on invested capital ("ROIC");
- Return on assets ("ROA");
- Return on equity ("ROE");
- EBITDA growth; and
- Cash flow (from operations) growth.

In October, ISS proposed shifting its capital productivity and profitability measures from GAAP-based measures of ROIC, ROA, and ROE to EVA concepts of "EVA spread" and "EVA margin," each measured over a three-year period. In addition, as proposed, measures of company progress would no longer be based on EBITDA growth and cash flow growth. Instead, EVA concepts of "EVA momentum," denominated by capital and sales, would be used to measure a company's economic growth trajectory.

While indicating that many institutional investors agreed with the direction it was taking to explore the incorporation of EVA factors into its analysis, ISS has decided not to replace the GAAP performance data with EVA performance measures in the FPA at this time. Therefore, ISS will continue to use accounting performance based on GAAP measures in the FPA for the 2019 proxy season.

Instead, EVA metrics will be featured in ISS reports for informational purposes on a phased-in basis over the 2019 proxy season. This will, in ISS' view, give all parties additional time to better understand the EVA methodology and its potential for adding insight to the "pay-for-performance" evaluation.

Observations. The decision to defer the switch to EVA metrics as part of the FPA screen at this time (along with the postponement of its director compensation evaluation policy as described below) may be viewed as an attempt by ISS to undertake a more deliberative process for reviewing and updating its policy guidelines. Nonetheless, it appears that ISS continues to believe that the use of EVA metrics represents a more standardized - and, therefore, more expedient – way to evaluate performance for purposes of the FPA test. Consequently, it would not be surprising to see ISS switch to EVA metrics as part of the quantitative portion of its "pay-for-performance" methodology in the future.

Preliminary FAQs Affect Other Current Policies

In addition to the foregoing, on November 21, 2019 ISS published preliminary responses to a handful of Frequently-Asked Questions ("FAQs") including questions about its director compensation evaluation policy and Equity Plan Scorecard tool. These FAQs offer valuable insights into ISS' plans for the 2019 proxy season concerning these major policy areas.

Director Compensation Evaluation

During the 2018 proxy season, ISS introduced a new policy providing that it would recommend a vote against the members of the board committee responsible for setting and/or approving non-employee director compensation if it determined that there was a pattern (that is, two or more years) of awarding "excessive" non-employee director compensation without disclosing a compelling rationale or other mitigating factors for such compensation. While not impacting vote recommendations in 2018, unfavorable voting recommendations were to be issued beginning in 2019 where a pattern of excessive non-employee director compensation is identified in consecutive years.

In response to feedback received through its policy development process, ISS has now announced that it intends to revise its methodology for identifying non-employee director pay outliers for purposes of this policy. As a result, ISS will not be issuing adverse director recommendations under this policy in 2019. Instead, the first unfavorable vote recommendation under the policy will be delayed until 2020.

Equity Plan Scorecard ("EPSC")

ISS does not plan to change the passing scores for any of its U.S. Equity Plan Scorecard models for 2019. Passing scores will remain the same as in effect for the 2018 proxy season. However, ISS has

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indicated that there will be weighting/point reallocations among some of the individual factors within each model. The details of these reallocations may be disclosed in the future.

In addition, a new negative "overriding" factor relating to excessive share capital dilution for the S&P 500 and Russell 3000 EPSC models only will be introduced in 2019. Under the EPSC, regardless of the number of points earned under the applicable equity plan model, certain plan features, such as the ability to reprice or exchange "underwater" stock options without shareholder approval or the presence of certain "liberal" change in control provisions, may lead to an automatic against recommendation from ISS. These "overriding" factors will now be joined by this "excessive" share capital dilution factor. This factor will be triggered when a company's employee stock plan is estimated to dilute shareholders' interests by more than 20% (for the S&P 500 model) or 25% (for the Russell 3000 model). This overriding factor will examine share capital dilution (as opposed to voting power dilution) calculated as: (A + B + C) ÷ CSO, where:

- A equals the number of new shares requested;
- B equals the number of shares that remain available for issuance;
- C equals the number of unexercised/unvested outstanding awards; and
- CSO equals the number of common shares outstanding.

A further substantive modification is being made to the change in control vesting factor to provide points based on the quality of the disclosure about change in control vesting provisions, rather than based on the actual vesting treatment of awards. Specifically, full points will be awarded where a company's employee stock plan discloses with specificity the change in control vesting treatment for both performance-based and time-based awards. Where the plan is silent on such vesting treatment for either type of award, or if the plan provides for merely discretionary vesting for either type of award, then no points will be awarded for this factor.

Like the policies discussed above, these changes will be effective for annual meetings of shareholders taking place on or after February 1, 2019.

What's Next?

In December, ISS will publish its updated benchmark voting policy guidelines as well as an FAQ document (in addition to the Preliminary FAQs described above). As in prior years, these materials will be posted to the ISS website.

And, as in past years, we expect ISS to be publishing updated "burn rates" for each GICS industry/index group in December.

Need Assistance?

Compensia has significant experience in helping companies understand and address ISS' corporate governance and executive compensation policies. If you have any questions on the topics covered in this Thoughtful Pay Alert or would like assistance is assessing how the policies are likely to affect your executive compensation program, please feel free to contact Jason Borrevik at 408.876.4035 or Mark A. Borges at 415.462.2995.■

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