ISS Provides Peek at Possible Policy Updates for 2017 Proxy Season

As it does each summer, Institutional Shareholder Services ("ISS") has published its annual policy survey soliciting input from interested parties on potential changes to its guideline policies for the 2017 proxy season. The survey is the initial step in its annual global benchmark policy formulation process. ISS will use the feedback received from the survey as one factor in determining whether to modify existing policies and/or introduce new policies that will inform its voting recommendations for its proxy advisory clients during 2017.

Change to Pay-for-Performance Methodology under Consideration

After relatively few policy changes involving executive compensation in recent years, ISS has raised a question in an area that may portend a significant change in 2017. This potential change involves its pay-for-performance methodology. Currently, ISS policy uses total shareholder return ("TSR") measured over various time horizons on a relative and absolute basis in its quantitative "screen" to identify a possible misalignment between company performance and CEO pay. ISS is soliciting feedback on whether other financial measures (in addition to TSR) should be incorporated into the pay-for-performance screen. ISS also solicits input on which measures should be included, such as revenue measures (such as total revenue or revenue growth), earnings measures (such as EPS or EBITDA), return measures (such as ROA or ROE), return on investment measures (such as ROIC), cash flow measures (such as OCF or FFO), and economic profit measures.

A change to its current methodology would represent a significant development in the evolution of ISS' quantitative screen, which, since its inception, has focused solely on TSR for comparative purposes. This emphasis is cited as contributing to the increase in the use of TSR as a performance measure in the incentive compensation plans of public companies. If ISS were to introduce one or more new financial measures into its methodology, it could lead companies to re-evaluate the inclusion and/or prominence of TSR in the design of their incentive pay plans.

Further, this could be a welcome development in light of the pending SEC rule on compensation recovery ("clawback") policies. As proposed, TSR is one of the financial reporting measures that would be subject to such polices; potentially creating tension for companies seeking to align their incentive pay plans with the ISS methodology while minimizing their exposure to the required clawback policy. We note that several commenters have urged the SEC to drop TSR as one of the measures that will subject an incentive compensation award to clawback, so it's possible that this tension will resolve itself even if, ultimately, ISS decides against revising its pay-for-performance methodology.

Possible Corporate Governance Policy Changes

In addition, the corporate governance issues affecting U.S. companies under consideration for revision are as follows:

"Overboarding." ISS notes that approximately 11% of the companies in the Russell 3000 have an executive chair of their Board of Directors who is not also the CEO. Its current policy considers an executive chair to be "overboarded" if he or she serves on more than five total boards (the same number applicable to non-executive directors) rather than the number applicable to CEO-chairs (two outside boards). ISS is soliciting feedback as to whether executive chairs should be evaluated based on the CEO standard (no more than three total boards) instead of the non-executive chair standard (no more than five total boards).

Dual-Class Stock Structure for IPO Companies. Currently, ISS recommends voting against directors at companies that, when they conduct their IPO, maintain "shareholder-unfriendly" corporate governance provisions, such as a classified board or a supermajority vote requirement to amend the by-laws. ISS is soliciting feedback on whether this policy should be extended to situation where a company that conducts its IPO is adopting (or has adopted)

ISS Provides Peek at Possible Policy Updates for 2017 Proxy Season (continued)

a structure that includes multiple classes of stock with unequal voting rights.

Board Refreshment. ISS indicates that lengthy director tenure has been identified by some commentators as a potential obstacle to adding new skill sets and diversity to boards and a potential risk to the independence of long-serving directors. To better understand how various constituencies view this issue, ISS is soliciting feedback about the tenure factors (if any) that would raise concerns with a board's nominating and refreshment processes. The enumerated factors may include any or all of the following:

- the absence of new independent directors in a recent period (for example, the last five years);
- lengthy average tenure on the board (for example, average service greater than 10 or 15 years); or
- a high proportion of directors with long tenure (for example, 75% of the boards, having tenures of 10 years or more).

Say-On-Pay Frequency Vote. Since most U.S. companies will be holding a shareholder advisory vote on the frequency of future shareholder advisory votes on executive compensation (a so-called "Say-on-Pay Frequency" vote) during the 2017 proxy season (the first such vote since the mandatory Say-on-Pay vote requirement became effective in 2011), ISS is soliciting feedback on whether annual, biennial or triennial votes are favored. Where a respondent indicates that the answer depends on the specific company, ISS asks which of the following factors – company size, financial performance, the presence (or absence) of problematic pay practices, or the prior level of support on the Say-on-Pay proposal – should be considered in making the determination.

Next Steps

Interested parties should complete **the survey** by **August 30th**. Typically, the survey is followed by a series of "roundtables" and additional outreach activities, culminating in the publication of proposed policy changes for public comment in the fall. A formal announcement of any policy changes in effect for the 2017 proxy season will be made in November.

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 us. ■

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