

ISS Seeks Input on Potential 2019 Voting Policy Updates

As it does each summer, Institutional Shareholder Services (“ISS”) has published its annual policy survey soliciting input from companies, investors, and other interested parties on potential changes to its voting guideline policies for the 2019 proxy season. The survey is the initial step in its annual global benchmark policy formulation process. ISS uses 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 beginning in 2019.

The survey consists of two parts - the first part, the Governance Principles Survey, focuses on high-level governance issues across the globe, while the second part, the Policy Application Survey, looks at issues affecting specific geographic regions.

Addition of EVA to “Pay-for-Performance” Methodology under Consideration

For the 2018 proxy season, ISS added a new component – the Financial Performance Assessment (“FPA”) test – to the quantitative “screening” portion of its methodology for evaluating executive compensation programs for purposes of issuing a voting recommendation on a Say-on-Pay proposal. This component, which involves comparing a company’s financial and operational performance against its ISS-constructed peer group over a three-year period using three or four of the following financial metrics – return on invested capital, return on assets, return on equity, EBITDA growth, and cash flow (from operations) growth – was used as a “secondary” measure that only came into play after the three traditional quantitative tests (the Multiple of Median test, the Relative Degree of Alignment test, and the Pay-TSR Alignment test) had been performed.

Citing the widespread use of non-GAAP financial metrics to report a company’s underlying business performance, as well as the lack of uniformity in the definition of such metrics, ISS notes that many investors have expressed a preference for addi-

tional financial metrics to be added to its quantitative “pay-for-performance” screen. ISS goes on to indicate that it is exploring ways to improve the financial metrics used in its analysis and, among other things, is considering supplementing or replacing the GAAP-based accounting metrics in the FPA test with economic value added (“EVA”)–based metrics to measure corporate economic performance.

After stating its belief that EVA provides a strong framework for comparing performance across companies of varying business models and capital structures, ISS is soliciting feedback from investors on their view of the current “pay-for-performance” screen based on the following three alternatives:

- ISS should use adjusted and standardized financial measures related to EVA or Economic Profit supplementing or replacing reported GAAP-based measures;
- ISS should continue to use reported GAAP-based measures (that is, maintain the current framework); or
- ISS should no longer use performance measures other than TSR.

Refinement of Excessive Director Compensation Policy

Beginning with the 2018 proxy season, ISS introduced a new policy providing for an “against” recommendation for the members of the board committee responsible for setting and/or approving non-employee director compensation if there is 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.

As part of the current survey, ISS is seeking input on what constitutes reasonable explanations for multiple consecutive years of “outlier” director pay. While ISS has requested examples of any reasonable rationale to justify the high director pay, it presents three possible explanations for consideration:

- Special payments related to corporate transactions or other special circumstances (for example, special committee service or diligence requirements upon a merger);

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- Payments in consideration of scientific or other topical expertise; or
- Payments to reward for performance or “extraordinary service.”

Other Possible Corporate Governance Policy Changes

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

One-Share, One-Vote Principle. Observing the growing number of companies with multi-class stock structures, ISS is soliciting feedback on whether, for purposes of evaluating board responsiveness to shareholder vote results, it should provide an adjusted analysis of shareholder vote results to show what the results would have been if all votes had been counted under the “one-share, one-vote” principle. ISS is also asking whether this adjusted analysis should be used to determine the need for board responsiveness to the results of a shareholder vote result in the following year. Finally, noting that many investors support the use of unequal voting rights structures in some instances if the structure is subject to an automatic “sunset” requirement, ISS is soliciting feedback on the appropriate timeframe for such a sunset provision.

Gender Diversity. Citing its 2017 policy survey which found that more than two-thirds of respondents considered it problematic if a public company had no female directors on its board and that a significant proportion of respondents (43%) considered the absence of female directors a possible indicator of problems with the board recruitment process, ISS is revisiting the same questions asked in the 2017 survey to identify changes, if any, in investor and non-investor views on this topic. These questions include whether respondents consider the absence of female directors on a public company board to be problematic and, if so, the actions they consider appropriate to address this situation.

Next Steps

Interested parties should complete the first part of the [ISS Governance Principles Survey](#) by 5:00 p.m. (ET), August 24, 2018. Responses to the second part of the survey, the Policy Application Survey, which is more in-depth, are not required until 5:00 p.m. (ET), September 21, 2018.

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 2019 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 in assessing how the policies are likely to affect your executive compensation program, please feel free to contact us. ■

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About Compensia

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