ISS 2019 Policy Updates May Affect Board Gender Diversity and Pay-for-Performance Methodology

As it does each fall, Institutional Shareholder Services ("ISS"), the corporate governance advisory services firm, has published a preview of some of the likely updates to its corporate governance policies for U.S. companies for the 2019 proxy season. Although it is not a comprehensive summary of all of the policy changes that may apply in 2019, the preview highlights two potentially significant items for the Boards of Directors of technology and life sciences companies. Specifically, ISS is considering:

- A new policy that would trigger an unfavorable recommendation for the chair of the Board Nominating Committee if there is no gender diversity on the Board of Directors; and
- A change to its quantitative screening methodology for evaluating the relationship between pay and performance for a company's executive officers that would revise the Financial Performance Assessment ("FPA") screen to replace unadjusted GAAP accounting measures with economic value added ("EVA") metrics.

ISS has provided companies, shareholders, and other market participants with a limited time to comment on the proposed policy updates before it finalizes the policies for next year. Comments must be received by November 1, 2018. ISS plans to issue its final 2019 U.S. and International Policy updates during the middle of November.

ISS' updated policies will be effective for annual meetings of shareholders held after February 1, 2019.

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, including a comprehensive "Executive Compensation Evaluation" policy statement, 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 and director compensation policies and practices.

On October 18, 2018, as a prelude to the publication of its policy guidelines for 2019, ISS announced that it was soliciting comments from companies, shareholders, and other market participants on a number of the policy updates under consideration. While the proposed updates to do not reflect all of the policies that will apply during the 2019 proxy season, they represent the more significant issues that have been percolating just under the surface in recent years and often portend areas where ISS plans to exercise scrutiny going forward.

Board Gender Diversity

Acknowledging 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. Taking this one step further, ISS is now proposing a new voting policy on directors for companies with no female directors serving on their boards.

The new policy, which would be **effective for annual meetings of shareholders on or after February 1, 2020**, would apply to companies in either the Russell 3000 or the S&P 1500 indices. Specifically, following the 2019 "grace period," adverse voting recommendations may be issued against the chair of the nominating committee at Boards of Directors with no gender diversity. In addition, 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 proposed, in special circumstances, the policy would allow the absence of board gender diversity to be explained and excused. Mitigating factors that may excuse non-compliance would 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

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board at the immediately preceding annual meeting, and/or any other compelling factors.

Observations

The proposed gender diversity policy is just the latest development in the growing effort to ensure an appropriate response to public sentiment concerning the low number of women on corporate boards. As described in our recent Thoughtful Pay Alert, *New California Law Promotes Gender Parity on Corporate Boards of Directors* (Oct. 5, 2018), the State of California just enacted a new law requiring that the boards of directors of publicly-held corporations with their principal executive offices located in the state have a specified minimum number of female members on their Board of Directors. Further, some institutional investors (such as BlackRock and State Street) have made this a practice that they want to see from their portfolio companies. The ISS policy would simply mirror this broader trend and put pressure on the projected 10% of companies in the Russell 3000 without such board representation to fall in line with current practice.

Pay-for-Performance Methodology

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 that only comes into play after the three traditional quantitative tests (the Multiple of Median ("MOM") test, the Relative Degree of Alignment ("RDA") test, and the Pay-TSR Alignment ("PTA") test) have been performed, 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.

Currently, in situations where the FPA comes into play, ISS uses unadjusted GAAP accounting data to conduct the test. ISS is proposing to update the FPA performance measures to use Economic Value Added ("EVA") metrics in place of unadjusted GAAP measures as an enhancement to the screen. As ISS notes, this proposal concerns purely the metrics used in the FPA secondary screen, which impact a limited number of pay-for-performance assessments.

Specifically, ISS is proposing to shift 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, measures of company progress no longer would 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.

ISS believes that the introduction of EVA will improve its analysis (in situations where the FPA is used) because it provides a standardized view of economic performance versus accounting results. Indeed, EVA results in the application of a series of uniform, rules-based adjustments to financial statement data, while accounting adjustments often vary among companies. In ISS' view, using EVA will enable it to improve the comparability of companies across different industries. Ultimately, ISS notes, using EVA metrics for the secondary screen will create a more reliable and accurate view of company performance. We expect that, as has been the case with past changes to the pay-for-performance methodology, ISS will be providing additional detail on these metrics, including formal definitions, once it publishes its final policy updates in November.

Observations

With respect to the proposed change to the FPA, we understand that the overall framework of the screen will be maintained. Thus, it will come into play only after the three traditional tests (RDA, MOM, and PTA) are applied and where a company is a "medium" overall concern or a "low" overall concern but bordering the "medium" concern threshold under the three traditional tests. If a company would have a "low" concern under the three traditional tests, but the result is bordering the "medium" concern threshold, a showing of relatively poor fundamental financial performance in the FPA may increase the final quantitative concern level to "medium." On the other hand, if a company would have a "medium" concern under the three traditional tests, a showing of relatively strong fundamental financial performance in the FPA may reduce the final quantitative concern level to "low." As ISS notes, only a limited number of companies were subjected to the FPA test during the 2018 proxy season and, based on its preliminary back-testing, should not materially increase the number of companies that received "low" or "medium" quantitative concern level results as part of its analysis.

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While the proposal represents a significant change to the FPA test, it may make it easier for companies to model the likely outcome of an ISS analysis where they believe that they could fall into a questionable category. Further, each EVA metric will be equally weighted and the weightings will be the same for all companies in the same industry, potentially eliminating some of the current uncertainty about how the FPA will affect a specific company or group of companies. Finally, ISS has indicated that EVA data, as well as certain explanatory materials, will be provided free of charge to all covered issuers for their own company in advance of their annual meeting of shareholders and ISS analysis.

What's Next?

ISS is soliciting comments on its proposed policy updates until November 1, 2018. ISS has indicated that it plans to issue its policy updates for 2019 during the middle 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, 2019.

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

Need Assistance?

Compensia has extensive experience in assisting companies in addressing ISS' U.S. benchmark voting policy guidelines. If you would like assistance in analyzing the potential impact of the ISS policies on your executive compensation program, 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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