ISS Publishes Final FAQs and Burn Rate Tables for 2019 Proxy Season

As expected, Institutional Shareholder Services ("ISS") published several supplemental documents in December that elaborate on the updates to its U.S. executive compensation benchmark policy guidelines for 2019. These documents include Frequently-Asked Questions ("FAQs") for both its U.S. compensation policies and U.S. equity compensation plans. At the same time, ISS also published its updated equity compensation burn rate tables for the 2019 proxy season.

This Thoughtful Pay Alert summarizes the key ISS executive compensation-related policy updates for 2019. A summary of ISS' benchmark policy changes for 2019 are available at the following link. These updates will be effective for annual meetings of shareholders taking place on or after February 1, 2019.

Executive Compensation Policy FAQs

While ISS made no major substantive changes to its U.S. benchmark voting policies for the 2019 proxy season, it updated its executive compensation policy FAQs in the following respects:

Pay-for-Performance Evaluation

ISS has made no changes for 2019 to the quantitative "screening" portion of its pay-for-performance methodology for evaluating executive compensation programs for purposes of issuing a voting recommendation on a Say-on-Pay proposal. The Financial Performance Assessment ("FPA") screen, which serves as a "secondary" screening "modifier" to the pay-for-performance methodology and compares a company's financial and operational performance against its ISS-constructed peer group over a three-year period, will continue to use GAAP/accounting performance measures.

However, ISS has indicated that it will continue to explore the potential for future use of Economic Value Added ("EVA") measures to add additional insight into a company's financial performance. To that end, EVA measures will be displayed in ISS research reports on a phased-in basis over the 2019 proxy season, although not as part of the quantitative pay-for-performance screen.

Interestingly, in spite of its heavy reliance on total shareholder return ("TSR") in the quantitative screen, ISS states in the FAQs that it does not endorse or prefer the use of TSR or any specific metric in incentive compensation programs for executives. Instead, ISS indicates that it believes that a company's Board of Directors (or Board Compensation Committee) is generally best qualified to determine the incentive plan metrics that will encourage executive decision-making that promotes long-term shareholder value creation.

"Front-Loaded" Equity Awards

In response to the increase in large, multi-year equity awards that have been granted by certain companies, ISS indicates that it is unlikely to support such awards that are intended to cover more than four years (that is, the grant year plus three future years). In its view, very large awards that are intended to cover multiple future years limit the ability of the Board of Directors to meaningfully adjust future pay opportunities in the event of unforeseen events or changes in either performance or strategic focus.

ISS goes on to state that, in its qualitative review of these "front-loaded" equity awards, commitments from the company not to grant additional awards over the covered period should be firm. Further, since such awards typically provide for exceptionally large pay opportunities, usual "pay-for-performance" considerations will be more closely scrutinized, including the thoroughness of the attendant disclosure, an emphasis on transparent and rigorous performance criteria, and stringent vesting provisions that limit the risk of a "windfall."

"Excessive" Director Compensation

As previously reported, 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 ("NED") compensation if it was determined that there was a recurring pattern (that is, two or more years) of awarding "excessive" non-employee director compensation without a compelling rationale 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 NED compensation is identified in consecutive years.

In response to investor feedback, ISS has updated its methodology for identifying "excessive" NED compensation. As before, following a quantitative identification of a director pay outlier, a

ISS Publishes Final FAQs and Burn Rate Tables for 2019 Proxy Season (continued)

qualitative evaluation of the company's disclosure will determine if concerns are adequately mitigated.

The methodology for identifying NED pay outliers has been revised to identify pay outliers representing individual director pay figures above the top 2-3% of all comparable directors. ISS will compare individual director pay totals within the same index and sector. Directors will be compared to other directors within the same two-digit GICS group and within the same index grouping. Index groupings for purposes of the policy are as follows: S&P 500, combined S&P 400 and S&P 600, the remainder of the Russell 3000 Index, and the Russell 3000 - Extended.

The revised methodology also recognizes that Board-level leadership positions (which, for this purpose, are limited to non-executive chairs and lead independent directors) often are addressed with a pay premium as compared to other directors. For NEDs who serve in these board leadership positions, the policy will identify outliers as compared to others within the same category of board leadership (still considering sector and index).

The revised methodology also considers limited instances of narrow distributions of NED pay within any particular sector-index grouping. In groups where there is not a pronounced difference in pay magnitude between the top 2-3% of directors and the median director, this may be considered as a mitigating factor.

In consideration of this methodology change, adverse voting recommendations will not be issued under this policy until annual meetings of shareholders occurring on or after Feb. 1, 2020 (that is, for companies where ISS has identified excessive NED pay without a compelling rationale in both 2019 and 2020). In evaluating a company's disclosed rationale, the following circumstances, if within reason and adequately explained, would typically mitigate concern about high NED pay:

- "Onboarding" awards for new directors that are clearly identified to be one-time in nature;
- Special payments related to corporate transactions or special circumstances (such as special committee service or requirements related to extraordinary need); or
- Payments made in consideration of specialized scientific expertise (as may be necessary in certain industries (such as the biotechnology and pharmaceutical sectors)).

Payments in connection with separate consulting agreements will be assessed on a case-by-case basis with particular focus on the company's rationale. Payments to reward general performance or service will generally not be viewed as constituting a compelling rationale.

"Good Reason" Termination Definitions

ISS has updated its list of problematic pay practices that carry significant weight and which will, in and of themselves, likely result in an adverse vote recommendation to include "problematic" definitions of what constitutes a "good reason" termination of employment. In ISS' view, change-in-control severance payments in connection with a "good reason" termination should be limited to circumstances that are reasonably viewed as an adverse constructive termination (that is, employer actions that result in a material negative change to an executive's title or role, function or compensation). Further, such provisions should be tailored to preclude potential risk of a "windfall" payment. To that end, definitions that are triggered by circumstances reflecting potential performance failures, such as a company bankruptcy or delisting, will be considered "problematic."

Smaller Reporting Companies

In 2018, the Securities and Exchange Commission revised the threshold standards for "smaller reporting company" ("SRC") status, making it easier for some public companies currently subject to the SEC's full reporting requirements to qualify to use the scaled reporting system available to SRCs. ISS notes that while SRCs are eligible for reduced executive compensation disclosure, they are still required to hold Say on Pay votes. ISS goes on to state that the completeness of disclosure is an important "pay-for-performance" consideration. Thus, companies with scaled compensation disclosure requirements should continue to provide sufficient disclosure to enable shareholders to make an informed "Say on Pay" vote. ISS indicates that it is unlikely to support a "Say on Pay" proposal if a company's executive compensation disclosure is such that shareholders cannot meaningfully assess the Board of Directors' compensation philosophy and practices.

Section 162(m) Revisions

As expected, ISS has not changed its position on the percentage of performance-based pay that it believes should comprise executive compensation packages just because the "performance-based compensation" exception to Section 162(m) of the Internal Revenue Code has been eliminated. ISS notes that while the tax deduction for performance-based pay afforded under Section 162(m) provided an added benefit to companies, it was seldom a primary reason behind shareholders' expectations for performance-based programs. ISS goes on to state that any shift away from performance-based compensation to discretionary or fixed pay elements will be viewed negatively.

ISS Publishes Final FAQs and Burn Rate Tables for 2019 Proxy Season (continued)

Equity Plan Scorecard FAQs

ISS has made several revisions to its "Equity Plan Scorecard," the methodology that it employs to evaluate management proposals to adopt a new equity compensation plan or amend an existing plan. As reflected in the FAQs, these changes are as follows:

Equity Plan Scorecard ("EPSC") Policies

While the EPSC passing score thresholds – 55 points (for the S&P 500 model) or 53 points (for other models) – to receive a favorable vote recommendation (absent overriding/egregious factors) remain unchanged, ISS has made several other updates to its EPSC methodology:

- *Change in Control Vesting* – The change in control vesting factor has been updated to provide points based on the quality of disclosure of change in control vesting provisions (essentially, whether discretionary vesting is permitted or prohibited), rather than based on the actual vesting treatment of awards. Full points will be earned if the plan discloses with specificity the change in control vesting treatment for both time-based and performance-based awards. If the plan is silent on the 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 earned for this factor.
- *"Excessive" Dilution* – A new negative overriding factor relating to excessively dilutive equity compensation plans has been introduced. Under this factor, ISS may recommend a vote against the equity plan proposal if the plan is potentially highly dilutive to shareholders' holdings. This overriding factor is triggered when the company's equity compensation plan is estimated to dilute shareholders' holdings by more than 20% (for the S&P 500 model) or 25% (for the Russell 3000 model). This factor does not apply to the Non-Russell 3000 or Special Cases models.

  This factor examines share capital dilution (as opposed to voting power dilution) which is commonly referred to as "total equity overhang" and is calculated as: (A + B + C) ÷ CSO, where: A = the number of new shares requested; B = the number of shares that remain available for issuance; C = the number of unexercised/unvested outstanding awards; and CSO = the common shares outstanding.
- *Plan Re-Submission to Shareholders* – Certain factor scores have been adjusted, per ISS' proprietary scoring model. Among these adjustments, weighting on the plan duration factor has increased to encourage plan resubmission to shareholders more often than listing exchanges require (and following the changes to Section 162(m) that decreased the incentive for periodic shareholder re-approval).

Section 162(m) Plan Proposals and Amendments

To comply with the "grandfather rule" relating to the elimination of the "performance-based compensation" exception to the Section 162(m) tax deduction limitation, ISS expects that equity plan proposals will continue to appear on the annual meeting agenda for continued Section 162(m) qualification. Further, its evaluation of Section 162(m)-related proposals will remain consistent with prior years.

Proposals that only seek approval to ensure tax deductibility of awards pursuant to Section 162(m) under the grandfather rule – and that do not seek additional shares for grants or approval of any plan amendments – will generally receive a favorable recommendation regardless of EPSC factors ("positive override"), provided that the Board Compensation Committee is 100% independent according to ISS standards.

Plan amendments that involve removal of general references to Section 162(m) qualification will be viewed as administrative and, therefore, neutral. This includes references to approved metrics for use in performance plan-based awards.

Of greater significance is ISS' view of the various requirements for qualifying for the "performance-based compensation" exception that are recognized by shareholders as good, or "best," practice. If a plan contains provisions representing good governance practices, even if no longer required for purposes of Section 162(m), their removal may be viewed as a negative change in a plan amendment evaluation. For example, the removal of individual award limits would be viewed as a negative change. Consequently, ISS encourages companies to maintain plan provisions that represent good governance practices, even if they are no longer required under Section 162(m).

Burn Rate Tables

Each year, ISS updates its burn rate tables and stated benchmarks for S&P 500, Russell 3000 (excluding the S&P 500), and non-Russell 3000 companies for the upcoming proxy season. Generally, ISS measures "burn rate" using the total number of equity awards (full value stock awards and stock options) granted in a given year (or earned for performance-based awards if sufficient disclosure) and expresses the computation as a percentage of the number of common shares outstanding. These tables set ISS' burn rate benchmarks (based on one standard deviation above the industry mean) using Standard & Poor's global industry classification standard ("GICS") codes as assigned to each company.

ISS Publishes Final FAQs and Burn Rate Tables for 2019 Proxy Season (continued)

ISS' updated 2019 burn rate tables, which apply to annual meetings of shareholders held on or after February 1, 2019, are set forth in the Exhibit to this article.

The burn rate benchmark is primarily used by ISS as part of its EPSC evaluations. The specific benchmark for each industry sector is a point in the middle of the sliding scale. Full credit is given to companies with burn rates at 50% of the burn rate benchmark or less. Companies with burn rates above 50% of the burn rate benchmark will earn partial (or even negative) credit based on a sliding scale.

If a company grants both full value stock awards and stock options, ISS applies a premium or "multiplier" to the full value awards for the past three fiscal years to equate them economically with stock options. For 2019, this premium or "multiplier," is unchanged from prior years as follows:

Stock Price Volatility	Multiplier (Full Value Awards to Option Shares)
54.6% or higher	1 award = 1.5 option shares
36.1% or higher and less than 54.6%	1 award = 2.0 option shares
24.9% or higher and less than 36.1%	1 award = 2.5 option shares
16.5% or higher and less than 24.9%	1 award = 3.0 option shares
7.9% or higher and less than 16.5%	1 award = 3.5 option shares
Less than 7.9%	1 award = 4.0 option shares

Observations. While ISS' burn rate methodology remains the same as in 2018, the 2019 burn rate benchmarks for key technology and life science industry sectors are generally slightly higher, with two notable exceptions – the benchmark for the S&P 500 Information Technology sector is down by 0.26% to 4.84% and the benchmark for the Russell 3000 Software & Services sector went down by nearly one point (0.87%) to 9.35%.

Companies should consider these updated benchmarks as one factor in their annual equity strategy review. Companies that developed equity budgets for 2019 with consideration of the then-current 2018 limits may have more or less flexibility with their equity compensation plans than originally anticipated (depending on program goals, equity plan funding, competitive needs, etc.).

Further Information

To obtain a copy of each of the materials discussed in this article, please click on the applicable link:

- ISS 2019 U.S. Equity Compensation Plans FAQs:
  Please click here.
- ISS 2019 U.S. Executive Compensation Policies FAQs:
  Please click here.

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.■

ISS Publishes Final FAQs and Burn Rate Tables for 2019 Proxy Season (continued)

Exhibit A

ISS 2019 Burn Rate Limits

GICS	Description	S&P 500	Δ from 2018	R3000 (Ex. S&P 500)	Δ from 2018	Non-R3000	Δ from 2018
1010	Energy	2.00%	0.00%	3.99%	0.25%	4.55%	-1.49%
1510	Materials	2.00%	0.00%	2.72%	0.11%	5.23%	-0.39%
2010	Capital Goods	2.04%	0.04%	3.75%	0.05%	6.33%	0.48%
2020	Commercial & Professional Services	2.04%	0.04%	3.80%	-0.44%	9.06%	-0.34%
2030	Transportation	2.04%	0.04%	3.39%	0.73%	4.51%	-2.00%
2510	Automobiles & Components	2.70%	0.30%	3.00%	0.00%	5.58%	-0.65%
2520	Consumer Durables & Apparel	2.70%	0.30%	3.81%	0.01%	5.00%	-0.26%
2530	Consumer Services	2.70%	0.30%	5.41%	-0.14%	4.89%	0.71%
2540	Media (moved to GICS 5020)	--	--	--	--	--	--
2550	Retailing	2.70%	0.30%	6.13%	1.93%	6.86%	0.33%
3010	Food & Staples Retailing	2.00%	0.00%	3.03%	0.38%	9.00%	1.43%
3020	Food Beverage & Tobacco	2.00%	0.00%	2.38%	0.01%	9.00%	1.43%
3030	Household & Personal Goods	2.00%	0.00%	4.13%	-0.80%	9.00%	1.43%
3510	Health Care Equipment & Services	2.48%	-0.04%	6.48%	0.79%	8.63%	0.30%
3520	Pharmaceuticals & Biotechnology	2.48%	-0.04%	6.98%	-0.10%	9.86%	1.14%
4010	Banks	3.04%	-0.20%	2.81%	-0.12%	5.11%	-0.59%
4020	Diversified Financials	3.04%	-0.20%	8.58%	-0.05%	5.11%	-0.59%
4030	Insurance	3.04%	-0.20%	4.26%	-0.10%	5.11%	-0.59%
4510	Software & Services	4.58%	-0.26%	9.35%	-0.87%	9.24%	-0.24%
4520	Technology Hardware & Equipment	4.58%	-0.26%	6.41%	0.25%	7.87%	0.11%
4530	Semiconductor & Semi Equipment	4.58%	-0.26%	6.61%	0.29%	6.63%	-0.64%
5010	Telecommunication Services	3.41%	1.41%	9.10%	2.00%	8.08%	-2.00%
5020	Media & Entertainment	3.41%	--	7.40%	--	8.08%	--
5510	Utilities	2.00%	0.00%	2.43%	0.34%	2.83%	-2.00%
6010	Real Estate	2.88%	0.88%	2.58%	-0.24%	3.07%	-2.00%

NOTE:
- GICS 2540 Media is no longer active
- New GICS 5020 Media & Entertainment
- Full value award volatility multipliers/buckets remain unchanged

About Compensia

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management.

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