ISS Issues 2020 Benchmark Policy Updates

Institutional Shareholder Services ("ISS"), the corporate governance advisory services firm, has announced the updates to its U.S. benchmark voting policy guidelines for 2020. The key executive compensation-related updates involve a pair of significant changes to its quantitative pay-for-performance "screening" model for evaluating executive compensation programs as well as adding the presence of an "evergreen" provision to its list of problematic pay practices under its Equity Plan Scorecard. On the corporate governance side, ISS has added a new policy for recent IPO companies that adopt a multi-class stock structure. A summary of ISS' benchmark policy changes for 2020 is available here.

In addition, on November 21, 2019 ISS published a set of preliminary Frequently Asked Questions ("FAQs") to address some of the most commonly received questions regarding the upcoming changes to its quantitative pay-for-performance methodology and its Equity Plan Scorecard, in advance of the more detailed information to be provided in the comprehensive updates to the FAQs later this year. The preliminary FAQs are available here.

ISS' updated policies will be effective for annual meetings of shareholders held on or after February 1, 2020.

This Thoughtful Pay Alert summarizes the information currently available from ISS on the executive compensation and corporate governance-related policy updates for 2020.

Executive Compensation-Related Policy Updates

ISS has made two changes to its quantitative pay-for-performance model for evaluating the executive compensation programs of U.S. companies for the 2020 proxy season. These changes are as follows:

Pay-for-Performance Model - Change to Quantitative Test Thresholds

ISS has adjusted the thresholds that trigger concern on two of the three tests employed in its quantitative evaluation of a company's executive compensation program, the Relative Degree of Alignment ("RDA") test and the Pay-TSR Alignment ("PTA") test. By raising the threshold triggers, it should make it less likely that a company will be subject to a detailed qualitative review of its compensation program and, thus, at risk for an unfavorable vote recommendation on its Say-on-Pay proposal. The changes to the applicable thresholds are as follows:

2019 vs. 2020 Quantitative Thresholds: All U.S. Companies				
Measure	Policy Year	Eligible for FPA Adjustment	Medium Concern	High Concern
Relative Degree of Alignment	2019	-28	-40	-50
Relative Degree of Alignment	**2020**	**-38**	**-50**	**-60**
Pay-TSR Alignment	2019	-13%	-20%	-35%
Pay-TSR Alignment	**2020**	**-22%**	**-30%**	**-45%**

While ISS did not make a change to the thresholds for its third quantitative test – the Multiple of Median ("MoM") test – it did indicate that, going forward, its research reports will now feature a three-year MoM view of CEO pay as a measure of long-term pay on a relative basis. This three-year MoM will be displayed for informational purposes only.

Pay-for-Performance Model - Use of Economic Value Added Metrics in Secondary Screen

ISS has changed its quantitative pay-for-performance model for evaluating the executive compensation programs of U.S. companies to incorporate the use of economic value added ("EVA") metrics in the model's secondary Financial Performance Assessment ("FPA") screen. Generally, the FPA screen, compares a company's financial and operational performance against its ISS-constructed peer group over a three-year period. The new EVA-based metrics – EVA Margin, EVA Spread, EVA Momentum vs. Sales, and EVA Momentum vs. Capital – replace the GAAP-based metrics that were used in the screen in prior years. While the GAAP metrics will continue to be displayed in ISS' research reports for informational purposes (and may inform its overall evaluation of long-term pay and performance alignment), they will no longer be a part of its pay-for-performance screens. Other than this change, the basic operation of the FPA as a secondary modifier screen will be the same. Consequently, it is expected that it will only affect a relatively small number of companies.

Detailed information about the incorporation of EVA metrics into the FPA screen will be provided by ISS in an updated Pay-for-

Performance Mechanics whitepaper to be published on its website in early- to mid-December.

Equity Plan Scorecard ("EPSC")

ISS is not changing the passing scores for any of its U.S. EPSC models for 2020. Passing scores will remain the same as in effect for the 2019 proxy season (55 points for S&P 500 companies and 53 points for all other companies). However, ISS has 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.

"Evergreen" Provisions

In addition, a new negative "overriding" factor relating to "evergreen" provisions (that is, provisions that automatically replenish an equity plan share reserve for a specified number of shares on an annual basis) has been added to the EPSC for 2020. With the repeal of the "performance-based compensation" exemption for purposes of Section 162(m) of the Internal Revenue Code (which required, as a condition of the exemption, that incentive plan metrics be approved by shareholders at least every five years), ISS notes that the number of equity compensation plans being submitted for shareholder approval has declined noticeably. As a result, plans containing "evergreen" provisions (as well as many other shareholder-unfriendly features) can now go for a significantly extended period of time without shareholder review or oversight.

In response to this development, ISS will recommend a vote against a proposal to adopt or amend an equity compensation plan which contains an "evergreen" provision. In our experience, most companies with "evergreen" provisions in their equity compensation plans do not seek shareholder approval of plan amendments, which suggests that this policy change may have relatively limited practical impact.

"Excessive" Director Pay

After a one-year delay, ISS' previously-announced policy to recommend a vote against directors responsible for setting non-employee director pay when there is a recurring pattern (two or more years) of excessive pay amounts without a compelling justification goes into effect for the 2020 proxy season.

To identify "pay outliers" (that is, individual non-employee directors with pay amounts above the top 2-3% of all comparable directors), ISS will compare directors against other directors within the same two-digit GICS group and within the same index grouping (that is, the S&P500, combined S&P400 and S&P600, remainder of the Russell 3000 Index, and the Russell 3000-Extended). In the case of directors holding board-level leadership positions, ISS will identify outliers as compared to others within the same board leadership category (still based on index and sector).

Following a quantitative identification of a non-employee director pay outlier, ISS will conduct a qualitative evaluation of a company's disclosure to determine whether its concerns are adequately mitigated. In evaluating a company's stated rationale for its pay levels, typically concern will be mitigated if the pay involves one of the following circumstances:

- An onboarding grant for a new director that is clearly identified to be one-time in nature;
- A special payment related to corporate transactions or special circumstances (such as special committee service or requirements related to extraordinary need); or
- A payment made in consideration of specialized scientific expertise (as may be necessary in certain industries such as biotech/pharma).

While ISS did not issue any adverse director recommendations under this policy in 2019, pay outliers that were identified in 2019 may be at risk for an adverse vote recommendation in 2020 if the "excessive" pay issue has continued for the second consecutive year.

Corporate Governance-Related Policy Updates

Newly-Public Companies with Problematic Capital Structures

ISS has updated its policy on problematic corporate governance structures at newly-public companies to add a policy for companies with multi-class capital structures with unequal voting rights. ISS will generally recommend a vote against the entire board of directors (except new nominees, who will be considered on a case-by-case basis) of a newly-public company if, prior to or in connection with the company's IPO, the company or the board implemented a multi-class capital structure in which the classes have unequal voting rights without subjecting the structure to a reasonable time-based sunset. In assessing the reasonableness of a time-based sunset provision, ISS will consider the company's lifespan, its post-IPO ownership structure, and the board's disclosed rationale for the sunset period selected. **However, no sunset period of more than seven years from the date of the IPO will be considered to be reasonable.** ISS confirmed that it will continue to issue unfavorable vote recommendations for the members of the board in subsequent years unless the problematic capital structure is reversed or removed.

Independent Board Chair Shareholder Proposals

Under its current policy, ISS will generally recommend a vote for a shareholder proposal requiring that the board chair position be filled by an independent director, after taking into consideration the scope and rationale of the proposal, the company's current board leadership structure, the company's governance structure and practices, the company's performance, and any other relevant factors that may be applicable.

Consistent with this approach, ISS has updated the factors that it will consider when analyzing a shareholder proposal to separate the board chair and CEO roles. Although maintaining a "holistic" approach to evaluating these proposals, the revised policy now indicates that the following factors will be given substantial weight in its analysis:

- A majority non-independent board and/or the presence of non-independent directors on key board committees;
- a weak or poorly defined lead independent director role that fails to serve as an appropriate counterbalance to a combined CEO/chair role;
- the presence of an executive or non-independent chair in addition to the CEO; a recent recombination of the role of CEO and chair; and/or departure from a structure with an independent chair;
- evidence that the board has failed to oversee and address material risks facing the company;
- a material governance failure, particularly if the board has failed to adequately respond to shareholder concerns or if the board has materially diminished shareholder rights; or
- evidence that the board has failed to intervene when management's interests are contrary to shareholders' interests.

Where ISS identifies the presence of such factors, it will generally recommend support for the proposal.

Board Gender Diversity

With the one-year transition period now having expired, ISS' new board gender diversity policy will go into effect in 2020. Thus, absent a firm commitment from the company to achieve gender diversity within a year, ISS will recommend a vote against the chair of the nominating committee (or other directors on a case-by-case basis), where there are no women on the board of directors. In addition, ISS has clarified that any such a commitment from a board with no female directors previously will only be a mitigating factor for 2020, not beyond.

Further, going forward, having board gender diversity the previous year but not in the current year will not alone prevent an unfavorable vote recommendation. In this situation, a company will need to acknowledge the current lack of a gender-diverse board and make a firm commitment to re-achieving board gender diversity by the following year. For this purpose, a "firm commitment" will be considered to be a plan, with measurable goals, describing how the board will achieve gender diversity.

Other Corporate Governance-Related Policy Updates

- *Shareholder Proposals on Gender Pay Gap* – ISS has updated its current policy on shareholder proposals seeking a report on a company's pay data by gender or on the company's policies and goals to reduce any gender pay gap to also include requests for such reports on the basis of race or ethnicity.
- *Problematic Governance Structures* – ISS has streamlined its policy with respect to problematic governance provisions to provide that at newly-public companies it will recommend a vote against directors individually, committee members, or the entire board of directors (except new nominees, who will be considered on a case-by-case basis) if, prior to or in connection with its IPO, the company or the board has adopted by-law or charter provisions that require a supermajority vote requirement to amend the bylaws or charter, impose a classified board structure, or reflect other egregious practices.
- *Open-Market Share Repurchase Program Management Proposals* – ISS will recommend a vote for a management proposal to institute an open-market share repurchase program in which all shareholders may participate on equal terms, or to grant the board authority to conduct open-market repurchases, in the absence of a series of enumerated company-specific concerns.
- *Restrictions on Binding Shareholder Proposals* – ISS will recommend a vote against the members of the board governance committee if the company places undue restrictions on the ability of shareholders to submit proposals amending the company's by-laws.
- *Exemptions for new director nominees* – ISS has clarified its policy for recommending how to vote for a director-nominee who is being presented to shareholders for the first time. While previously ISS has indicated that new nominees will be considered on a case-by-case basis, the revised policy makes clear that this only will apply to new nominees who have served for less than one year.

- *Director Attendance* – ISS has clarified that its policy to recommend a vote against directors who attend less than 75% of the aggregate of their board and committee meetings for the period for which they served will not apply to nominees who served only part of the fiscal year under review, who will be considered case-by-case.

What's Next?

Each year, ISS publishes its U.S. benchmark voting policy guidelines (as updated for the items discussed herein), an updated Frequently-Asked Questions ("FAQ") document, and a Pay-for-Performance Mechanics whitepaper designed to help stakeholders understand upcoming changes to its compensation-related methodologies. As in prior years, these materials will be published in early- to mid-December 2019 and 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 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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