ISS Releases U.S. Executive Compensation Policies and U.S. Equity Compensation Plans FAQ Documents

By Brian Johnson

Last week, ISS released their U.S. Executive Compensation Policies and U.S. Equity Compensation Plans FAQ documents. These documents are intended to provide greater detail on the updates ISS has implemented to their executive compensation and equity plan policies for annual meetings occurring after February 1, 2017. This alert provides a summary of the key updates as disclosed in the FAQ material.

Based on our review, the three most significant updates disclosed in the FAQ documents are as follows:

- Relative financial performance will be measured on a trailing 12- and 16-quarter basis, with the cutoff dates for measuring performance based on the company's annual meeting date
  - The new relative financial performance evaluation is part of ISS's *qualitative* review of a company's pay program, and is separate from ISS's *quantitative* pay-for-performance assessment, which utilizes relative total shareholder return to measure company performance (see previous Viewpoint for overview discussion)

- Payment of bonuses despite failure to achieve pre-established threshold performance criteria will now be considered a problematic pay practice under ISS's policy

- Under ISS's Equity Plan Scorecard (EPSC) model, the minimum vesting factor will now apply to all awards under the equity plan, and the minimum vesting requirement cannot be reduced through individual award agreements

The full detail of the ISS updates are discussed below.

1. <u>**U.S. Executive Compensation Policies**</u>

- **Relative Pay and Financial Performance Assessment**
  - Financial performance will be measured over the trailing 12 quarters (16 quarters for growth metrics) as of the applicable Quarterly Data Download (QDD) for each company for the following operational performance metrics:
    - Return on invested capital (ROIC)
    - Return on assets (ROA)
    - Return on equity (ROE)
    - EBITDA growth

        - Cash flow (from operations) growth
        - Revenue growth
    - The QDD dates are based on the annual meeting date for each company as follows:

Shareholder Meeting Date	QDD
March 1 to May 31	December 1
June 1 to August 31	March 1
September 1 to November 30	June 1
December 1 to February 29	September 1

    - The evaluation utilizes reported, rather than adjusted, performance results, in order to provide for a reasonable comparison across all companies
    - The weights of each metric will vary by the four-digit GICS industry group, and not all industries will use all metrics
    - The weighted average performance rank is compared to the company's CEO pay rank (similar to the Relative Degree of Alignment test), creating a relative financial performance result
    - ISS has indicated that no thresholds or concern levels have been established for the relative financial assessment, and that the evaluation is part of their qualitative review to determine if appropriate linkages exist between CEO pay and company performance
- **Total Compensation Calculation**
    - ISS has indicated that, as of December 2016, all stock-based awards (both time-based and performance-based) will be calculated by multiplying the number of underlying shares (target number for performance awards) by the closing stock price on the grant date
    - Previously, ISS had utilized grant date value for stock awards, generally as reported in the Grants of Plan-Based Awards table, subject to certain adjustments based on ISS's assessment of the grant
- **Time Period for Application of Quantitative Tests**
    - ISS has indicated that, for companies with less than three years of public trading history, the RDA measure will be based on two years of data. If less than two years of data are available, the RDA measure will not be run
    - Previously, for companies with less than three years of public trading history, ISS would base the RDA measure on as many complete years of annualized TSR and CEO pay data as were available (e.g. RDA measure could be based on one year of TSR/CEO pay)
- **Problematic Pay Practices (new factor)**
    - Payment of bonuses despite failure to achieve pre-established threshold performance criteria
- **Absence of Say-on-Pay Vote Without Sufficient Explanation for Omission**

  - If a company does not include a Say-on-Pay or Say-on-Pay Frequency vote on the ballot where one would otherwise be expected, and the company does not provide an explanation for the omission, ISS will make an AGAINST vote recommendation for the compensation committee chair (or entire committee, as appropriate) until the company presents an advisory vote on executive compensation to shareholders
  - Companies that are exempt from Say-on-Pay requirements due to "emerging growth company" status under the JOBS Act should provide an explanation of this in the proxy statement
- **Advisory Vote on Golden Parachutes**
  - ISS has added new criteria that will be reviewed when evaluating the treatment of equity awards upon a change-in-control
  - New factors that will be reviewed include maintaining of vesting criteria for converted awards and magnitude of accelerated awards

2. U.S. Equity Compensation Plans

- **Disclosure of Performance-Based Awards for Burn Rate Calculation**
  - ISS has indicated that additional disclosure will be required for performance awards to be captured in their burn rate calculation on the basis of when they are earned, not granted, in a fiscal year
  - ISS will now require separate tabular disclosure of performance awards, with grants and earned amounts per fiscal year covering the past three fiscal years, in either the company's 10K or proxy statement
  - Disclosure of aggregate share totals for all equity awards granted from all plans to all participants is required
  - ISS will generally not engage in calculations to determine earned amounts, even if such calculations may be possible based on the company's narrative disclosure
- **Plan Amendment to Increase the Tax Withholding Rate Applicable Upon Award Settlement**
  - ISS has indicated that plan amendments to increase the tax withholding rate applicable upon award settlement will be viewed negatively if the plan contains a liberal share recycling feature
  - ISS believes this type of amendment, when coupled with liberal share recycling provisions, would exacerbate concerns regarding diminished transparency of share usage inherent to liberal share recycling
  - This concern can be mitigated under ISS's policy if the plan stipulates that only the number of shares withheld at the minimum statutory rate may be recycled, even if the tax withholding is at a higher rate
- **Payment of Dividends on Unvested Awards (new EPSC factor)**
  - ISS added a new factor under the Plan Features pillar of the EPSC model that evaluates the payment of dividends on unvested awards

    - Full points will be earned if the equity plan expressly prohibits, for all award types, the payment of dividends before the vesting of the underlying award (however, accrual of dividends payable upon vesting is acceptable)
    - No points will be earned if this prohibition is absent or incomplete (i.e. not applicable to all award types)
- **Minimum Vesting Provisions for Equity Awards (updated EPSC factor)**
    - ISS has updated their minimum vesting factor so that full points are awarded only if the equity plan specifies a minimum vesting period of one year for all equity awards
    - No points will be earned if the plan allows for the administrator, through individual award agreements, to reduce or eliminate the one-year vesting requirement beyond the allowable carve-out of 5% of the reserve
    - Previously, the minimum vesting provision only need to apply to one type of equity award under the plan

General questions about this Viewpoint can be directed to Brian Johnson by email at brian.johnson@paygovernance.com.