ISS Releases Additional Guidance on its 2018 Voting Policy Changes

By: Jon Weinstein, Linda Pappas, Maggie Choi, and Jessica Morris

Introduction

Last month, Institutional Shareholder Services (ISS) released its 2018 voting policy updates for companies that have shareholder meetings on or after February 1, 2018. More recently, ISS revised its "Pay-for-Performance Mechanics" white paper, providing additional details on its 2018 policy changes, and updated its Frequently Asked Questions documents for both U.S. Compensation Policies and U.S. Compensation Plans. As many companies prepare for the upcoming proxy season, we are providing insight and additional guidance in navigating the latest ISS policy developments.

Key Takeaways

- *ISS released additional details on its 2018 methodology for assessing CEO P4P as part of its SOP voting criteria*
- *For 2018, ISS has introduced the relative FPA as a fourth, but supplemental, quantitative P4P screening criteria*
- *As the basis for its relative comparison, FPA focuses on unadjusted GAAP metrics, potentially leading to a disconnect with adjusted metrics disclosed in earnings releases or utilized within incentive plans*
- *The FPA outcome is expected to impact only a limited sample of companies: those that score an "initial concern level" of either "cautionary low concern" or "medium concern" and that have a relative FPA result significant enough to change the overall concern level*
- *Other notable ISS policy changes for 2018 include an assessment of "excessive" non-employee director pay, guidelines for evaluating gender pay gap shareholder proposals, and a call for increased disclosure related to shareholder engagement efforts*

CEO Pay-for-Performance (P4P) Assessment

Relative Financial Performance Assessment (FPA)

The introduction of a fourth test, the relative FPA, is the most noteworthy change to the quantitative CEO P4P assessment used by ISS to evaluate Say on Pay (SOP) proposals (and in certain cases, director elections). This relative FPA will be a supplemental analysis directly impacting a subset of the companies subject to ISS review. ISS will use this as a secondary quantitative screen after its three primary, total shareholder return (TSR)-based CEO P4P tests.

The new FPA quantitative test is largely similar to the "preview" of the relative financial performance review that was introduced by ISS in 2017 as part of its qualitative assessment of SOP proposals. ISS has narrowed its review to focus on either three or four metrics per company, which may include ROA, ROE, ROIC, EBITDA Growth, or Operating Cash Flow Growth. Over a span of three years, relative performance will be measured (i.e., average return or growth rate) and compared to a company's relative CEO pay rank.

It is important to note that ISS will continue to use as-reported Generally Accepted Accounting Principles (GAAP) metrics in its financial analysis. This contrasts with the adjusted financial metrics widely utilized by companies in earnings releases and incentive performance measures. As a result, adjustments deemed appropriate by a company (e.g., write-downs, impairments) have the potential to negatively impact the organization's FPA results for up to three years.

Consistent with last year, the financial metrics reviewed — as well as their ranking and weighting — will vary by industry group (defined by 4-digit Global Industry Classification Standard code). Although ISS has published the metrics used and relative rankings by industry, the specific *weightings* by industry remain undisclosed.

While the new financial test outcomes will be presented for all companies under ISS review, they will be consequential for only a limited group of companies that score either a "medium concern" or "cautionary low concern" on the primary TSR-based quantitative tests. If a company has an initial concern level of "cautionary low" and the relative FPA test result is substandard, ISS may downgrade the *overall* concern level to "medium concern." In contrast, if a company has an initial score of "medium concern" and the relative FPA test result is strong, ISS may upgrade the *overall* concern level to "low concern." In terms of impact, ISS has estimated that historically fewer than 5% of companies would have their overall quantitative score modified by FPA test results.

Other Key Changes to the P4P Evaluation

With its 2018 evaluations of the Multiple of Median test, ISS will lower the "medium concern" threshold for S&P 500 index companies from 2.33x to 2.00x. This means that a CEO with total compensation twice as high as the median ISS peer CEO will trigger "medium concern."

Also new for 2018, ISS will calculate TSR by using a one-month average share price at both the beginning and end of the measurement period.

The table below summarizes ISS's recent quantitative test changes.

	Quantitative Test		Low Concern	*Cautionary* Low Concern	Medium Concern	High Concern
Initial Quantitative Screening	**Relative Degree of Alignment**		+100 to -28.4	-28.4 to -40	-40 to -50	-50 to -100
	Multiple of Median	S&P 500:	0x to 1.64x	1.64x to 2.00x	2.00x to 3.33x	3.33x and above
		Non-S&P 500:	0x to 1.74x	1.74x to 2.33x	2.33x to 3.33x	3.33x and above
	Pay-TSR Alignment		+100% to -13%	-13% to -20%	-20% to -35%	-35% to -100%
	Financial Performance Assessment		Does not Apply	"Poor" score may lead to overall Medium	"Strong" score may lead to overall Low	Does Not Apply
	Overall Quantitative Assessment		**Low**	**Low or Medium**	**Low or Medium**	**High**

Other Notable Policy Changes

Excessive Non-Employee Director Pay

ISS is implementing a policy that could result in an "against" recommendation for director elections at companies with a recurring pattern of "excessive" board pay levels. Since ISS defines a recurring pattern as two or more consecutive years, this new policy will not impact vote recommendations in 2018; however, ISS is likely to increase its scrutiny in the upcoming proxy season. Directors responsible for setting/approving board compensation (typically, the Compensation or Governance/Nominating Committee) would be subject to the potential "against" recommendation.

In assessing non-employee director pay levels, ISS will compare each director's total pay to median total pay across all individual non-employee directors in the same index and industry. ISS is seeking out "extreme outliers," which they have historically identified as pay in the top 5%. Where there is a recurring pattern of "excessive" pay, ISS may refrain from recommending "against" elections if a company discloses a compelling rationale or other mitigating factors for its director pay levels.

Shareholder Proposals on Gender Pay Gaps

ISS is introducing a policy to evaluate shareholder proposals related to gender pay equity. Such shareholder proposals have commonly sought additional disclosure of gender pay equity and any policies/goals to reduce existing gender pay gaps.

ISS's new policy states that support for gender pay equity proposals will be handled on a case-by-case basis, taking the following criteria into account:

- Any current diversity/inclusion policies, disclosures, and practices
- Any compensation philosophy and/or use of fair and equitable compensation practices
- Any recent controversies, litigation, or regulatory actions related to gender pay gap issues
- Any lag on gender pay gap policy/initiatives in comparison to peers

Shareholder Engagement following Poor Say-on-Pay Votes

ISS has augmented its policy for evaluating compensation committee members elected from a SOP vote garnering less than 70% of shareholder support. In these instances, ISS now expects companies to disclose:

- Engagement efforts with major institutional investors regarding the issues that resulted in low support
- Specific details on outreach effort frequency (e.g., company held X number of meetings with shareholders, representing Y% of its shareholder base) and whether independent directors participated in investor conversations
- Specific concerns of dissenting shareholders
- Specific and meaningful actions taken to address shareholder concerns

CEO Pay Ratio Disclosure

In response to the forthcoming required CEO pay ratio disclosure, ISS will begin displaying the median employee pay figure and CEO pay ratio in its research reports. For the first year, the CEO pay ratio will not have any policy implications (i.e., will not impact vote recommendations), but ISS will continue to assess CEO pay ratio data as more information becomes available.

Evaluation of Equity Plan Proposals

ISS will continue to conduct its balanced scorecard approach, or Equity Plan Scorecard, when evaluating equity plan proposals. Modest updates were announced for 2018 and mostly reflect simplified scoring for several existing plan feature and grant practice factors. For example:

- *Change in Control (CIC) Vesting* — ISS will only award full points where plans prohibit automatic acceleration or Committee discretion and will specify that performance-based award payouts upon CIC are either pro-rata at target or based on actual performance
- *Minimum Vesting Requirement* — Ratable vesting (where a portion of an award may vest earlier than the one-year anniversary of the grant date) will not qualify for full points under the one-year minimum vesting requirement
- *Board Discretion to Accelerate Vesting* — ISS will award full points only if plans limit Committee or Board discretion to accelerate awards for cases of death or disability
- *CEO Vesting* – ISS will reduce its requirement for earning full points to a vesting period of three or more years (a decrease from four or more)
- *Holding Requirement* — ISS will reduce its requirement for earning full points to companies that have holding periods of 12 months or longer (a decrease from 36 months), and points will no longer be awarded for having a holding requirement until ownership guidelines are met

Conclusions

As companies prepare for the upcoming calendar year, including pay decisions and related Compensation Discussion & Analysis (CD&A) disclosure, there are a number of items to keep in mind:

- Consider the impact the revised CEO P4P methodology may have on your company's quantitative score, including whether the new FPA test may be applicable
- Consider whether it makes sense to include a detailed rationale within your proxy CD&A disclosure for any recent adjustments to the metrics being evaluated by ISS under the new FPA test, if applicable
- Consider any revised equity plan scorecard implications if proposing a new or amended equity plan for 2018

As ISS begins applying the 2018 policy changes, Pay Governance will continue to ensure companies stay apprised of how these changes may impact SOP, equity plan proposals, director elections, and shareholder proposals.

General questions about this Viewpoint can be directed via email to Jon Weinstein (jon.weinstein@paygovernance.com) or Linda Pappas (linda.pappas@paygovernance.com).