MERIDIAN
COMPENSATION PARTNERS, LLC

Institutional Shareholder Services Releases its 2018 Policy Survey Questionnaire

Institutional Shareholder Services (ISS) recently issued its policy survey questionnaire, which previews potential changes in ISS's 2018 proxy voting policies.

Through its annual policy survey, ISS seeks feedback from institutional investors, public companies, corporate directors and the consulting and legal communities on emerging trends in corporate governance, executive compensation and other matters as part of its policy formulation process. The policy survey often provides an advance read on where ISS is heading on a particular issue.

ISS recently released its 2018 Policy Survey questionnaire, which is divided into two parts – a Governance Principles Survey and a Policy Application Survey ("Survey"). The Survey includes questions regarding the following corporate governance and compensation matters:

- Gender diversity on Boards,
- CEO pay ratio disclosure,
- Use of realized or realizable pay in the ISS quantitative pay-for-performance methodology,
- Non-employee director pay, and
- Gender pay gap.

These questions are summarized below.

The Survey also includes questions regarding the "one-share, one-vote principle," share issuance and buyback proposals, virtual or hybrid shareholder meetings and short-term poison pills adopted without a shareholder vote.

The Governance Principles Survey will be open for participation until Thursday, August 31. The Survey can be completed online by going to the following webpage: https://www.surveymonkey.com/r/2018 ISS Policy Survey. Upon completion of the Governance Principles Survey, a respondent may answer the Policy Application Survey. The Policy Application Survey will be open until Wednesday, October 6.

The results of the Governance Principles Survey are expected to be published in late September. To provide ISS with a corporate perspective, we recommend that companies complete and submit the Survey, and consider gathering input from board members and major shareholders, as appropriate.

Gender Diversity on Boards

The Survey asks respondents to identify whether it is problematic for no female directors to be serving on a public company Board. The Survey offers the following responses:

- Yes, the absence of at least one female director may indicate problems in the Board recruitment process,
- Yes, but concerns may be mitigated if there is a disclosed policy/approach that describes the considerations taken into account by the nominating committee to increase gender diversity on the Board,
- No, directors are best-suited to determine the composition of the Board,
- Maybe, but the level of concern is based on a case-by-case determination (e.g., it depends on country of listing/domicile, type of company, industry sector or other factors).

If the respondent views the absence of gender diversity to be problematic, the Survey asks the respondent to identify which of the following actions may be appropriate for shareholders to take at a company that lacks any gender diversity on the Board and/or has not disclosed a policy on the issue.

- Engage with the Board and/or management,
- Consider supporting a shareholder proposal aimed at increasing diversity,
- Consider supporting a shareholder-nominated candidate to the Board,
- Consider voting against all members of the nominating/governance committee,
- Consider voting against the Board Chair or lead director, and/or
- Consider voting against the Reports & accounts (in markets where this is an option) reflecting poor disclosure of gender diversity.

Meridian Comment. ISS appears to be gauging investor interest in various mechanisms for promoting gender diversity on corporate Boards. This year, investors such as BlackRock and State Street have focused additional resources on this issue. Moreover, some recent studies found that the presence of female directors is correlated with stronger financial performance. Nevertheless, in the near-term, we believe that ISS is unlikely to adopt a new policy on gender diversity. However, we expect that ISS will continue to support shareholder proposals seeking increased Board diversity.

Pay Ratio Between Senior Executives and Employees

As U.S. public companies are expected to first disclose their CEO pay ratios in 2018 (unless the SEC's rule is repealed or its effective date is delayed), the Survey solicits information regarding how respondents will analyze pay ratio data. The Survey provides the following potential responses.

- Compare the ratios across companies or industry sectors,
- Assess year-over-year changes in the ratio at an individual company,
- Both of the above,
- My organization is not planning to use this information, or
- Other.

The Survey also asks respondents to identify how shareholders should use the proxy disclosed pay ratio data and provides the following potential responses.

- As one data point in determining votes on compensation-related resolutions,
- As one data point in determining votes on directors,
- As background material for engagement with a company,
- As a risk factor to be weighed in making investment decisions,
- The information as disclosed will not be meaningful to shareholders, or
- Other

Meridian Comment. As 2018 will be the initial year for public companies to disclose their respective CEO pay ratios, ISS appears to be seeking guidance as to how it should assess this disclosure. At least for 2018, we believe that ISS will take into account the CEO pay ratio when performing its holistic analysis of a company's pay programs. However, we do not believe that a company's CEO pay ratio, standing alone, would result in ISS recommending AGAINST a company's Say on Pay proposal. We further anticipate that ISS's proxy research reports will include a company's pay ratio information and, over time, comparative pay ratio data of peer companies.

In the future, ISS is likely to develop specific proxy voting policies on disclosed CEO pay ratios.

Outcomes-Based Compensation Measures

ISS is considering changing its methodology for assessing CEO pay and performance in the U.S. and Canada to take into account outcomes of performance-based pay programs using a "realizable" pay measure. The Survey asks whether a respondent supports the use of an outcomes-based measure, such as realizable pay, as part of ISS's quantitative pay-for-performance evaluation. The Survey further asks respondents who favor the use of an outcomes-based measure to identify whether ISS should use realizable pay as part of its quantitative pay-for-performance evaluation in any of the following ways.

- Realizable pay could migrate concerns regarding pay-TSR misalignment,
- Realizable pay could mitigate concerns regarding excessive pay quantum,
- Realizable pay could exacerbate concerns regarding excessive leverage to performance (e.g., large payouts to modest performance), and/or
- Other.

Meridian Comment. Currently, ISS includes a realizable pay analysis in its **qualitative** assessment of CEO compensation, when a potential pay-for-performance misalignment is found under ISS's three-part quantitative analysis (this quantitative analysis is limited to S&P 1500 companies). The feedback from the Survey may assist ISS in further developing a framework for assessing realizable pay outcomes in its qualitative evaluation. Whether ISS intends to incorporate the realizable pay assessment in its **quantitative** pay-for-performance evaluation is not clear from the Survey. In addition, issuers often have very different approaches to illustrating realizable and realized pay.

Non-Employee Director Pay

Under its current policy, ISS reviews non-employee director pay to determine whether a company has a pattern of excessive director compensation that calls into question director independence. To assess non-employee director pay, ISS compares director pay levels to other companies within the same index and GICS. If ISS finds a pattern of high non-employee pay levels at a company relative to peers, ISS will include cautionary language in its proxy research report.

The Survey asks respondents to identify which of the following factors ISS should consider in determining whether a non-employee director pay program presents a governance concern due to the magnitude of pay:

- Non-employee director pay relative to all companies.
- Non-employee director pay relative to relevant stock market index peers.
- Non-employee director pay relative to 4-digit GICS industry group peers.
- Other.

The Survey also asks respondents to identify whether any of the following compensation elements should be considered in determining whether a non-employee director pay program presents a governance concern with respect to a problematic pay structure.

- Stock option grants.
- Performance equity awards.
- Excessive perquisites.
- Non-retirement benefit programs.
- Retirement programs.
- Other.

The Survey asks respondents to identify whether any of the following actions are appropriate in cases where ISS has identified a pattern (i.e., multiple years) of relatively high pay levels at a company:

- ISS should identify the issue in its proxy analysis in year one, but generally the issue would not warrant an immediate adverse vote recommendation.
- ISS should issue adverse vote recommendations for members of the committee that approves non-employee director pay in year one.
- Committee members should only be held accountable for two or more consecutive years of high director pay or other problematic director pay practices (i.e., adverse recommendations in year two and beyond).
- Do not issue adverse vote recommendations for director related to problematic pay levels.
- Other.

Meridian Comment. ISS appears to be poised to develop a policy to evaluate non-employee director pay that would have an effect on its vote recommendations on directors. The possibility that ISS will evaluate the magnitude of director pay levels is a potential example of policy overreach. Among major U.S. public companies, we see a very **tight range** of both total compensation levels and design practices. In addition, relatively high director pay levels do not necessarily diminish a director's ability to serve as an independent steward or represent shareholder interests. ISS's current independence tests are sufficient and better indicators of whether a director has a conflict of interest or other concerns that may undermine his or her independence.

Gender Pay Gap

The Survey notes the increase in shareholder proposals over the last two years requesting disclosure on a company's gender pay gap. The Survey asks whether a company should disclose gender pay gap information. For a respondent that selects "it depends" to the preceding question, the Survey asks the respondent to identify which of the following circumstances should trigger a company's obligation to disclose gender pay gap information:

- Only if/when gender pay gap disclosure is required by governance regulations,
- If the practice has become an industry norm and/or the company is lagging its peers,
- If the company has experienced significant related controversies, or
- Other.

Meridian Comment*.* Currently, ISS does not have a formal policy on how it evaluates shareholder proposals on gender pay gap reporting. Interestingly, in 2017, ISS has recommended AGAINST 11 of 13 of such shareholder proposals. However, we expect that ISS will adopt a new policy, which would broaden the circumstances in which it would support such proposals.

* * * * *

The ***Client Update*** is prepared by Meridian Compensation Partners' Technical Team led by Donald Kalfen. Questions regarding this Client Update or executive compensation technical issues may be directed to Donald Kalfen at 847-235-3605 or dkalfen@meridiancp.com.