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Institutional Shareholder Services Releases its 2019 Policy Survey Questionnaire

Institutional Shareholder Services (ISS) recently issued its 2019 policy survey questionnaire, which previews potential changes in ISS's 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's Policy Survey questionnaire is divided into two parts – a Governance Principles Survey and a Policy Application Survey ("Survey"). The Governance Principles Survey covers a handful of global governance topics at a high level. The Policy Application Survey includes expansive and detailed questions on how ISS should evaluate specific proxy voting issues under its U.S. and/or Canadian proxy voting policies.

The Survey includes questions regarding the following compensation and corporation governance matters:

- The ISS quantitative pay-for-performance methodology for evaluating U.S. and Canadian companies.
- Non-employee director pay.
- Gender diversity on Boards.
- Board qualifications matrix.
- Director accountability for service on other Boards.

These questions are summarized below.

The Survey also includes questions on other governance topics such as auditor independence, audit committee effectiveness, "one-share, one-vote principle," shareholder proposals seeking to separate the CEO and Board Chair roles and minimum stock ownership requirements for binding bylaw amendments.

The Governance Principles Survey will be open for participation until Friday, August 24. The Policy Application Survey will be open until Friday, September 21. The Survey can be completed online by going to the following webpage: https://www.surveymonkey.com/r/ISSPolicySurvey. Upon completion of the Governance Principles Survey, a respondent may answer the Policy Application Survey.

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 public companies complete and submit the Survey, and consider gathering input from board members, as appropriate.

ISS Quantitative Pay-for-Performance Methodology (U.S. and Canada)

Currently, ISS's pay-for-performance evaluation for Russell 3000 and Toronto Stock Exchange listed companies includes a quantitative analysis comparison of CEO total pay and company performance, as measured in absolute terms as well as relative to an ISS-constructed peer group, using three test components. A company that receives either a "Cautionary Low" or a "Medium" level of concern on the initial quantitative pay-for-performance tests will be subject to ISS's relative financial performance analysis ("FPA") to determine the degree of scrutiny in the ISS qualitative pay-for-performance assessment. For purposes of the FPA test, ISS measures financial performance based on the three-year weighted average of three or four of the GAAP-based financial metrics.

ISS is considering changing its methodology for assessing CEO pay and performance in the U.S. and Canada by supplementing or replacing existing GAAP-based accounting metrics in the FPA with Economic Value Added (EVA) based metrics to measure corporate economic performance. EVA is a framework that applies a series of uniform, rules-based adjustments to financial statement accounting data, and aims to measure true underlying economic profit and capital productivity. ISS notes that many of the key measures in the current FPA, such as ROIC and EBITDA growth, have comparable evaluation points under the EVA framework.

The Survey asks respondents to describe their views on whether ISS should change how it measures performance under its quantitative pay-for-performance methodology. The Survey offers the following responses:

- ISS should use adjusted and standardized financial measures related to EVA or Economic Profit to supplement or replace reported GAAP-based measures.
- ISS should continue to use reported GAAP-based measures (i.e., maintain the current framework).
- ISS should no longer use performance measures other than TSR.
- Other.

Meridian Comment. As its rationale for this potential change to the ISS quantitative pay-for-performance methodology, ISS cites investor preferences and states, "[m]any companies report, and investors rely upon, non-GAAP metrics adjusted for various factors when evaluating financial performance under the view that they better reflect underlying business performance." ISS also states, "EVA provides a strong framework for comparing performance across companies of varying business models and capital structures."

This potential change to the ISS quantitative pay-for-performance methodology follows ISS's recent acquisition of EVA Dimensions, a New York-based firm that measures and values corporate performance based on the EVA framework. We suspect the focus on EVA may be due, in part, to an ISS strategy to sell EVA consulting services to public companies through EVA Dimensions.

Non-Employee Director Pay

Under its new proxy voting policy on non-employee director compensation, ISS will generally recommend shareholders vote AGAINST members of the board committee that are responsible for approving or setting non-employee director (NED) compensation if there is a pattern (i.e., 2 or more years) of "excessive" NED compensation without a disclosed compelling rationale or other mitigating factors. ISS is phasing in the new policy over the 2018 and 2019 proxy seasons. For this proxy season, ISS appears to be issuing cautionary notes to companies found to have "excessive" NED compensation. Starting with the 2019 proxy season, "excessive" NED compensation may result in ISS issuing a negative vote recommendation on applicable board committee members.

The Survey asks respondents to identify potentially reasonable rationales for high NED compensation. The Survey offers the following responses:

- Special payments related to corporate transactions or other special circumstances (e.g., special committee service or diligence requirements upon a merger, or requirements due to extraordinary need).
- Payments in consideration of scientific or other specific topical expertise.
- Payments to reward for performance or extraordinary service.
- Other.

Meridian Comment. ISS is seeking to identify reasonable explanations for relatively high NED compensation, indicating that ISS may clarify the circumstances under which it would deviate from a bright-line policy. However, ISS has not requested input on the most critical unsettled aspect of its methodology for evaluating NED compensation. Specifically, as discussed in our Client Update dated June 14, 2018, ISS has provided limited guidance on how it will determine whether NED compensation is "excessive."

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 or approach that describes the considerations taken into account by the Board or the nominating committee to increase gender diversity on the Board.
- Maybe, but the level of concern is based on a case-by-case determination (e.g., it depends on the country, type of company, industry sector or other factors).
- No, directors are best-suited to determining the composition of the Board.

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 chair of the nominating/governance committee.
- Consider voting against the chair of the board or lead director.

- Consider voting against “Discharge of Directors or the Report & Accounts” (in markets where this is an option) reflecting poor disclosure of gender diversity.
- Other.

Meridian Comment. For the second consecutive year, ISS appears to be gauging investor interest in various mechanisms for promoting gender diversity on corporate Boards. In 2017, investors such as BlackRock and State Street started focusing additional resources on this issue. 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.

Board Qualifications Matrix

ISS notes that many companies disclose in their proxy statements directors’ attributes in a collective manner or include directors’ skills and attributes in short individual textual biographies, rather than provide a matrix of skills and attributes. The Survey asks respondents to identify the level of disclosure about a director’s individual skills and attributes that would be useful to shareholders.

- Matrix with all individual directors’ relevant skills, gender and race/ethnicity.
- Matrix as above but with one with category such as “diversity” that aggregates gender, race and ethnic minority status.
- Cumulative information about the Board as a whole, such as a specific percent of diverse members, combined with director biographies and pictures.
- Short director biographies with pictures are sufficient.
- Other criteria should be applied.

Meridian Comment*.* ISS is seeking investor feedback on the usefulness of a board qualifications matrix following the second phase of the New York City Pension Funds (NYCPF) Boardroom Accountability Project. As described in our Client Update dated September 20, 2017, the NYCPF proposed a standardized matrix format for disclosing on Board composition and demographics.

In response to mounting pressure on corporate Boards to increase their diversity and to enhance their disclosure, some large cap public companies have started to disclose detailed information on Board composition, diversity and refreshment. However, despite the NYCPF campaign, companies have not adopted a standard format for this volitional proxy disclosure. In fact, as ISS acknowledges, some companies describe their directors’ attributes in a collective manner due to privacy concerns or to avoid the implication that a director has fewer qualifications than other directors have or was selected as a “token” director to meet demographic criteria.

Director Accountability for Service on Other Boards

The Survey asks respondents to identify whether investors would find it useful and appropriate for ISS to identify in its proxy research reports any individual director who received a negative ISS vote recommendation on the basis that the director failed in his/her oversight responsibilities at another company. The Survey offers the following responses:

- Yes, my organization would like to consider any identified oversight shortfalls by the director on other boards where he or she serves.

- No, my organization considers a director's service on each board on which he or she serves on a standalone basis.
- It depends.

The Survey further asks respondents to identify the types of "oversight shortfalls" that are relevant to an investor's assessment of director service in such situations and provides the following potential responses:

- Risk oversight failures relating to fraud or other forms of corporate malfeasance.
- Risk oversight failures related to business operations (such as cybersecurity).
- Oversight failures regarding protection of shareholder rights or shareholder value.
- Pattern of poor stewardship of compensation practices.
- Other.

The Survey also asks respondents to determine an appropriate look-back period for such oversight shortfalls and provides the following potential responses:

- One year.
- Three years.
- Five years.
- No time limit.
- Other.

Meridian Comment. ISS appears to be considering adding information in its proxy research reports to facilitate investor assessments of director performance on Boards other than the subject company's Board ("other Boards"). That may be the first step toward a new ISS policy to issue negative vote recommendations on a director who serves on multiple boards when ISS has raised concerns about the director's service on other Boards.

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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.