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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 generally 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.

One item of particular note is that ISS intends to incorporate Economic Value Added (EVA) metrics into the relative financial performance analysis ("FPA") component of its quantitative pay-for-performance test for U.S. and Canadian companies. We discuss this development in further detail below. Presumably, ISS's proposed policy updates, which will be released in October, will reflect changes in the FPA.

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

- The ISS quantitative pay-for-performance methodology for evaluating U.S. and Canadian companies
- Gender diversity on boards
- Director overboarding
- Shareholder proposals seeking to separate the Board Chair and CEO roles

These questions are summarized below.

The Survey also includes questions on other governance topics such as director accountability for failure to assess and mitigate climate change risk and sunset provisions for multi-class voting capital structures.

The Policy Survey will be open for participation until Friday, August 9. The Survey can be completed online by going to the following webpage: https://www.surveymonkey.com/r/2019-ISS-Policy-Survey. The results of the Policy Survey are expected to be published in 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. Meridian will be submitting a response as well.

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 three-part quantitative analysis which compares CEO total pay and company performance, as measured in absolute and relative terms to an ISS-constructed peer group. A company that receives either a "Cautionary Low" or a "Medium" level of concern under the initial quantitative analysis will be subject to the FPA, which will determine the degree to which ISS will scrutinize the company under its qualitative pay-for-performance assessment. For purposes of the FPA in its current form, ISS measures financial performance based on the three-year weighted average of three or four GAAP-based financial metrics.

In October 2018, ISS proposed changing its methodology for assessing CEO pay and performance at U.S. and Canadian companies by supplementing or replacing existing GAAP-based accounting metrics in the FPA with EVA-based metrics to measure corporate economic performance. However, based on investor feedback, ISS decided to leave the FPA assessment methodology unchanged for the 2019 proxy season and to disclose EVA metrics solely for informational purposes. ISS explained this would give investors more time to “understand the EVA methodology and its potential to add additional insight to pay-for-performance evaluation.”

In the Policy Survey, ISS states that it “plans to incorporate EVA metrics into the [FPA] for U.S. and Canadian pay-for-performance models.” ISS notes that four EVA metrics will be used in the FPA’s comparison of relative long-term financial performance and that the basic operation of the FPA will not change.

The Survey asks respondents to identify whether ISS should continue to display the GAAP metrics in ISS proxy research reports by choosing among the following responses.

- The prior-used GAAP-based metrics should be displayed below the FPA screen in the report as a point of comparison
- Display of the prior-used GAAP-based metrics is unnecessary
- Other

Meridian Comment. As its rationale for this potential change to the ISS quantitative pay-for-performance methodology, ISS states “EVA provides an improved framework for comparing performance across companies of varying business models and capital structures.” We think that this conclusion is too broad, especially for some industry sectors (e.g., financial services). However, the language of the Policy Survey strongly signals that ISS is likely to replace GAAP-based metrics with EVA metrics in the FPA as soon as the 2020 proxy season.

Gender Diversity on Boards

Last year, ISS announced that it would phase-in a policy on board gender diversity. Starting in 2020, ISS will generally recommend **AGAINST** the nominating committee chair (or other members of the committee on a case-by-case basis) if a company does not have any female directors serving on its board of directors, absent mitigating factors. This policy is applicable to component companies of the Russell 3000 or S&P 1500 indices.

The Survey indicates that ISS will consider the following mitigating factors prior to issuing a negative vote recommendation:

- A firm commitment, as stated in the company’s proxy statement, to appoint at least one woman to the board in the near term, such as within the next year
- The presence of at least one woman on the board at the time of the preceding annual meeting
- Other relevant mitigating factors on a case-by-case basis, if applicable

The Survey asks respondents whether any other mitigating factors would be sufficient to warrant a positive ISS vote recommendation despite the lack of at least one woman director on a company’s board.

Meridian Comment. Major public companies may view ISS's new policy on gender diversity on boards as directionally consistent with their own policies on board diversity and efforts to increase female, racial and ethnic representation on their respective boards. Therefore, we do not anticipate any significant pushback from large public companies on ISS's Board Gender Diversity policy.

Director Overboarding

Under current ISS policy, non-executive directors are considered "overboarded" if they serve on more than five public boards, or in the case of a CEO, more than two public boards (inclusive of the company where he or she is CEO). In such cases, ISS will recommend a vote **AGAINST** the director on that basis if he or she is standing for election.

ISS notes that "[s]ome large institutional investors have recently tightened their limits on director overboarding, presumably believing the time commitment required to be an effective Board member at a public company has increased in recent years." Given the evolving views of some large institutional investors, ISS is revisiting its director overboarding policy. *Specifically, the Survey asks what constitutes an acceptable number of directorships for non-executive directors and directors who are active CEOs (e.g., 4, 5 or 6 board seats for non-executive directors and 2 or 3 for active CEOs).*

Meridian Comment. ISS appears to be contemplating the adoption of a more stringent standard on overboarding to align with the evolving views of its institutional shareholder clients. Major institutional investors, such as Vanguard and BlackRock, have adopted stricter overboarding policies in recent years, which has contributed to a decline in shareholder support for directors standing for election, particularly, in the case of active public company executives sitting on more than two boards. We expect that other major institutional shareholders will adopt more stringent overboarding policies, increasing the pressure on directors to limit their board service and for companies to establish effective board refreshment processes in an increasingly tough recruiting market.

Shareholder Proposals Seeking to Separate the Board Chair and CEO Roles

Under current ISS policy, ISS generally recommends that shareholders vote **FOR** a shareholder proposal that requests that the position of Board Chair be filled by an independent director, after taking into consideration the scope of the proposal, the company's current board leadership structure, the company's governance structure and practices, company performance and any other relevant factors. *The Survey asks respondents to identify which of the following factors or circumstances would most strongly suggest the need for an independent Board Chair when evaluating such proposals:*

- A weak or poorly-defined lead director role
- Governance practices that weaken or reduce board accountability to shareholders (e.g., a classified board, plurality vote standard, inability of shareholders to call a special meeting and lack of a proxy access right)
- Lack of board refreshment or board diversity
- Poor responsiveness to shareholder concerns
- Long-term underperformance of the company relative to peer companies
- Scale/complexity of the business (i.e., a larger or more complex business indicating a greater need for stronger separation of the leadership roles)
- Excessive or poorly-structured executive compensation

- A corporate crisis (e.g., a serious regulatory scandal, security breach, accounting scandal or product/operational failure)
- Other

Meridian Comment. ISS appears poised to revise the factors that it considers in determining whether to support a shareholder proposal asking for an independent Board Chair. In its Policy Survey, ISS notes that the debate over the proper Board leadership structure continues in the U.S. where market participants disagree as to whether a lead independent director is a perfectly acceptable alternative to an independent Board Chair.

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The ***Client Update*** is prepared by Meridian Compensation Partners' Governance and Regulatory 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.