ISS Issues Final Policy Updates for 2020

On November 11, 2019, Institutional Shareholder Services (ISS) issued final updates to its proxy voting policies for 2020 and on November 21, 2019, ISS issued further guidance in its preliminary FAQs for 2020 compensation policies. The updates represent an incremental change to existing ISS policies and the implementation of phased-in policies related to non-employee director compensation and board gender diversity.

Final Policy/Process Updates for 2020

ISS has made the following modifications to its U.S. pay-for-performance assessment for 2020:

- Easing the quantitative concern thresholds under its initial three-part comparative quantitative analysis of CEO pay and company performance, and
- Using economic value added (EVA) measures in the secondary financial performance assessment component of the quantitative pay-for-performance analysis, instead of GAAP-based financial measures.

In addition, ISS has revised its proxy voting policies for U.S.-listed companies in the following areas relating to executive compensation and corporate governance:

- Evaluation of non-employee director compensation,
- Board gender diversity,
- Management proposals to approve share repurchase programs,
- Equity plan proposals in which a company's equity plan includes an evergreen provision,
- Shareholder proposals related to the separation of the Board Chair and CEO, and
- Shareholder proposals related to gender pay gaps.

The changes to the pay-for-performance assessment and other policy updates take effect for shareholder meetings occurring on or after February 1, 2020.

ISS Quantitative Pay-for-Performance Assessment

ISS is modifying its quantitative pay-for-performance assessment.

Current Approach

Currently, ISS's pay-for-performance evaluation for Russell 3000 companies includes a three-part quantitative analysis[1] of CEO pay and company performance, as measured in absolute terms and relative terms (i.e., relative to an ISS-constructed peer group). A company that receives either a "cautionary low" or a "medium" level of concern on any of these initial quantitative pay-for-performance tests will be subject to ISS's Financial Performance Assessment (FPA). Under the FPA, ISS measures a company's financial performance based on the three-year weighted average of three or four ISS-selected GAAP-based financial measures.

ISS uses the FPA result to modify its overall quantitative test concern level. Specifically, ISS may increase a "cautionary low" concern to "medium" concern if the company demonstrates poor performance based on the FPA evaluation ("elevated concern") and may decrease a "medium" concern to a "low" concern if the company shows strong financial performance based on the FPA evaluation ("mitigated concern"). A company that receives a "medium" or "high" overall concern level under the quantitative tests is subject to a more in-depth qualitative pay-for-performance assessment.

Based on the outcome of its pay-for-performance evaluation, ISS could issue a negative vote recommendation on a company's say on pay proposal, which can significantly affect vote outcomes.

New Approach

ISS is modifying its quantitative pay-for-performance assessment in the following respects:

- **As shown in the table below, ISS has raised the thresholds that trigger each respective concern level on the Relative Degree of Alignment (RDA) and Pay-TSR Alignment (PTA) components of the initial quantitative pay-for-performance evaluation**. ISS has not changed the thresholds that trigger concern on the Multiple of Median (MoM) test in 2020.

Comparison of 2019 and 2020 ISS Quantitative Pay-for-Performance Thresholds

Measure	Policy Year	Eligible for FPA Adjustment: Cautionary Low Concern	Eligible for FPA Adjustment: Medium Concern	Not Subject to FPA: High Concern
Relative Degree of Alignment	2019	-28	-40	-50
Relative Degree of Alignment	**2020**	**-38**	**-50**	**-60**
Pay-TSR Alignment	2019	-13%	-20%	-35%
Pay-TSR Alignment	**2020**	**-22%**	**-30%**	**-45%**
Multiple of Median Test (no change)	**2019/2020**			
S&P 500 Companies		1.64×	2.00×	3.33×
Russell 3000 Companies		1.74×	2.33×	3.33×

[1] These tests include the Relative Degree of Alignment (RDA) analysis, measuring the degree of alignment between total shareholder return (TSR) and CEO total pay over 3 years compared to ISS-determined peers; the Pay-TSR Alignment analysis, measuring the 5-year historical trend in CEO pay and company TSR; and the Multiple of Median (MoM) analysis, measuring a CEO's 1-year total pay relative to the ISS peer group median CEO total pay.

- **ISS will use EVA measures in the FPA in 2020, instead of the current GAAP-based financial measures**. Other than the change to EVA measures, the basic operation of the FPA (as explained above) will be the same. ISS will use the following EVA measures in the FPA: EVA margin, EVA spread, EVA momentum versus sales and EVA momentum versus capital.[2]

- **ISS will continue to include performance using GAAP-based financial measures *primarily* for informational purposes**. The GAAP-based measures *may* inform ISS's overall evaluation of long-term pay-for-performance alignment.

- **Exceptions to FPA**. ISS will not conduct the FPA test in exceptional cases, including those listed below.

  —Less than Two Years of Data. The FPA test may be inapplicable if a company has disclosed either CEO pay or the EVA measures for less than less than a two-year period.

  —REITs. The FPA test will not apply to Real Estate Investment Trusts (REITs) classified under GICS code 601010, because ISS is currently refining its methodology for calculating EVA for REITs.

- **ISS will include in its proxy research reports a 3-year Multiple of Median (MoM) of CEO pay *solely* for informational purposes**. ISS states that it will include the 3-year MoM as a measure of long-term pay on a relative basis.

Previously Announced Policy Changes Going Into Effect in 2020

ISS previously announced the following policy changes that take effect for the 2020 proxy season.

- **Evaluation of non-employee director (NED) compensation**. Starting in 2020, ISS will generally recommend **AGAINST** members of the board committee that are responsible for approving or setting NED compensation if ISS finds that there has been excessive NED compensation for two or more consecutive years without compelling rationale or mitigating factors. ISS will determine NED pay to be excessive if it falls within the top 2% to 3% of directors of public companies in the same index and 2-digit GICS industry as the subject company. ISS will use the following index groupings to evaluate NED pay levels: (i) S&P 500, (ii) the combined S&P 400 and S&P 600 indices, (iii) the remainder of the Russell 3000, and (iv) the Russell 3000-Extended. ISS will compare directors serving in board-level leadership positions, such as lead directors and non-executive Board Chairs, to others in the same role.

- **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 the Russell 3000 or S&P 1500 companies. The following factors may mitigate ISS concern regarding lack of board gender diversity:

  —A firm commitment to appoint at least one female director to the board within a year, as disclosed in the proxy statement (such a commitment will be a mitigating factor in 2020, but not thereafter),

[2]Fundamentally, EVA is a profitability metric. It is the best-known version of a class of financial performance measures known as economic profit. Distinct from accounting profit, economic profit/EVA is profitability with one additional charge – the cost of the capital employed to attain those profits. EVA Margin is a productivity ratio that reflects operational efficiency and asset management. EVA Spread measures how effectively a company is managing its capital base. EVA Momentum Versus Sales measures growth rate scaled to sales. EVA Momentum Versus Capital measures the progress a company is making at growing profitability.

—The presence of at least one female director on the board at the immediately preceding annual meeting (i.e., the female director is not a member of the board at the current annual meeting) and a firm commitment to appoint at least one female director to the board within a year, and

—Any other relevant factors as applicable.

Other ISS Policy Changes

ISS is revising its proxy voting policies for U.S.-listed companies in the following areas:

- **Management proposals to approve share repurchase programs**. ISS will generally recommend **FOR** a management proposal to: (i) institute open-market share repurchase program in which all shareholders may participate on equal terms, or (ii) grant the board authority to conduct open market repurchases unless the buyback program facilitates abusive practices. ISS will recommend **AGAINST** a management proposal to approve a share repurchase program if ISS identifies concerns regarding greenmail[3], the use of buybacks to inappropriately manipulate incentive compensation metrics, threats to the company's long-term viability, or any other company-specific factors. Historically, companies have rarely sought shareholder approval of share buyback programs.

- **Equity plan proposals in which a company's equity plan includes an evergreen provision**. ISS assesses equity plan proposals under its Equity Plan Scorecard (EPSC) under which it evaluates and scores fourteen discrete factors that fall under one of the following categories: (i) plan cost, (ii) plan features, and (iii) company grant practices. Generally, ISS will recommend **FOR** a company's equity plan proposal that yields a certain threshold score under the EPSC. However, ISS will generally recommend **AGAINST** on an equity plan proposal, irrespective of the EPSC score, if any egregious plan features or factors are present. ISS has updated its list of egregious plan features to include evergreen provisions (i.e., a provision that automatically replenishes an equity plan's share pool each year, without further shareholder approval).

- **Shareholder proposals related to gender pay gaps**. ISS revised its current policy on shareholder proposals related to the gender pay gap to cover proposals that request reporting on race and ethnicity pay gaps. The changes reflect the current scope of shareholder proposals on pay gap matters. Under the revised policy, ISS will evaluate, on a *case-by-case* basis, shareholder proposals requesting that a company report on: (i) pay data by gender, race or ethnicity, or (ii) policies and goals to reduce any gender, race or ethnical pay gap.

- **Shareholder proposals related to the separation of the Board Chair and CEO**. ISS revised its policy on shareholder proposals seeking to separate the Board Chair and CEO. The policy update largely codifies the existing ISS policy application. ISS will maintain a holistic approach to evaluating these proposals. However, under the revised policy, ISS has identified specific factors that will be given substantial weight in ISS's determination whether to support such a proposal. The presence of one or more of the following factors will increase the likelihood that ISS will recommend that shareholders vote **FOR** a shareholder proposal seeking an independent Board Chair:

  —A majority non-independent board and/or the presence of non-independent directors on key board committees,

[3] Greenmail refers to the practice of an individual or entity purchasing enough shares in a company to threaten a takeover, and then using that leverage to pressure the target company to repurchase those shares at a premium so that the greenmailer will abandon its takeover efforts.

—A weak or poorly-defined lead independent director role that fails to serve as an appropriate counterbalance to a combined CEO/chair role,

—The presence of an executive or non-independent chair in addition to the CEO, a recent recombination of the role of CEO and chair, and/or departure from a structure with an independent chair,

—Evidence that the board has failed to oversee and address material risks facing the company,

—A material governance failure (particularly if the board has failed to adequately respond to shareholder concerns or if the board has materially diminished shareholder rights), or

—Evidence that the board has failed to intervene when management's interests are contrary to shareholders' interests.

Meridian Comments. Overall, the 2020 ISS policy updates represent an incremental change to existing ISS policies.

On executive compensation matters, ISS's modifications to its quantitative pay-for-performance assessment of CEO pay may be the most significant policy/process change. The easing of the concern thresholds means that fewer companies should receive "medium" or "high" concern levels under the RDA and Pay-TSR Alignment assessments. For those companies for which the FPA test is the determinative factor in establishing the overall concern level, some investors and companies may find ISS's pay-for-performance determination problematic when EVA metrics and GAAP-based metrics yield conflicting conclusions regarding relative performance of a subject company.

The implementation of phased-in policies related to non-employee director compensation and board gender diversity represent significant changes to ISS policies. For the first time, ISS will be judging the reasonableness of non-employee director compensation. Although this is a new area of scrutiny by ISS, it should not prove problematic for the vast majority of large public companies. Also, ISS is prescribing that a company's board must include at least one woman director to avoid a negative vote recommendation on the chair of its nominating committee. In large part, events on the ground have mooted the new ISS policy on board gender diversify. Today, 100% of S&P 500 companies and 90% of Russell 3000 companies have at least one woman director serving on their board. Therefore, ISS's new board gender diversity policy will likely have the greatest impact on micro-cap and small cap companies and IPO companies, as these companies tend to lag behind larger public companies on implementing the most recent governance practices.

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