ISS Issues FAQ Related to 2019 US Compensation Policies

Skadden

12 / 20 / 18

If you have any questions regarding the matters discussed in this memorandum, please contact the attorneys listed on the last page or call your regular Skadden contact.

Four Times Square
New York, NY 10036
212.735.3000

On December 14, 2018, Institutional Shareholder Services (ISS) issued updated Frequently Asked Questions (FAQ) related to its U.S. Compensation Policies effective for shareholder meetings occurring on or after February 1, 2019. The more notable updates are summarized below.

Nonemployee Director Pay

In 2017, ISS introduced a policy providing for potential adverse vote recommendations for the members of a company's board of directors responsible for approving/setting nonemployee director (NED) pay in the event that ISS determines that there is an established pattern (two or more consecutive years) of excessive pay levels without a compelling rationale or other clearly explained mitigating factors. In November 2018, ISS announced that it would revise its methodology for identifying NED pay outliers and delay the first possible adverse vote recommendations under the policy until 2020 (see our previous alert here), which was confirmed in the FAQ.

The FAQ further provide the following insights about the updated methodology for evaluating NED pay:

- Pay outliers will be those NEDs with pay that exceeds the top 2-3 percent of all comparable directors (rather than the top 5 percent).
  - Individual NED pay totals will be evaluated within the context of a company's index (*e.g.*, S&P 500) and sector (two-digit Global Industry Classification Standard group).
  - Board leaders (limited to nonexecutive chairmen and lead independent directors) will be compared against other board leaders.
  - The lack of a pronounced difference in pay between the top 2-3 percent of NEDs and the median director in a given sector-index grouping may be a mitigating factor.
- If ISS determines that a NED's pay is a quantitative pay outlier, it will perform a qualitative evaluation of the company's disclosed rationale to determine if concerns are adequately mitigated. The following fact patterns typically would mitigate concerns, provided they are within reason and adequately explained:
  - new director onboarding grants clearly identified as one-time in nature;
  - special payments related to corporate transactions or special circumstances (*e.g.*, special committee service); or
  - payments made for necessary, specialized scientific expertise.

Payments to reward general performance typically will not be considered a compelling mitigating factor, and payments made in connection with separate consulting agreements will be assessed on a case-by-case basis.

Problematic Pay Practices

ISS previously had identified certain "problematic pay practices" that are likely to cause additional scrutiny of compensation committee members and say-on-pay vote proposals, and it also previously had separately identified certain of such practices as likely on their own to result in a negative say-on-pay vote recommendation.

ISS Issues FAQ Related to 2019 US Compensation Policies

Shift away from performance pay/162(m) repeal. ISS has added as a problematic pay practice a shift away from performance-based compensation to discretionary or fixed pay elements, including changes made in light of the repeal of the performance-based compensation exception under Internal Revenue Code Section 162(m).

Additional particularly problematic pay practices. ISS has added the following to its list of particularly problematic pay practices:

- excess termination (no longer just change in control severance) payments — *i.e.*, generally those exceeding three times base pay and annual bonus; and
- a "good reason" termination definition that presents windfall risks, such as definitions triggered by potential performance failures, such as a company bankruptcy or delisting.

Miscellaneous

Pay-for-performance screens. ISS confirmed that, while there are no changes to its quantitative pay-for-performance screens for 2019, it will continue to explore the potential use of an economic value added (EVA) measure and begin to display EVA results in its research reports. As to the qualitative screens, ISS added a new consideration — the emphasis of objective and transparent metrics. ISS also expressly noted that, while investors prefer emphasis on objective and transparent metrics, it does not endorse or prefer the use of total shareholder return or any other specific metric.

Front-loaded awards. ISS for the first time expressly addressed "front-loaded" awards and said that it is unlikely to support grants that cover more than four years and that a company's commitment not to grant additional awards over the covered period should be firm.

Meaning of "material" amendment. ISS previously had made clear that if an automatically renewing/extending employment agreement is not materially amended, its automatic extension will not on its own result in a negative say-on-pay vote recommendation, even where the agreement contains a problematic pay practice. ISS has now made clear that an amendment is "material" for this purpose if it involves any change that is not merely administrative or clarifying.

CEO pay ratio. ISS reiterated that a company's CEO pay ratio will not at this time impact its vote recommendations but that its research reports will continue to display the company's median employee pay figure and the pay ratio for not only the current year but also, if available, the prior year as well.

Contacts

Neil M. Leff
Partner / New York
212.735.3269
neil.leff@skadden.com

Regina Olshan
Partner / New York
212.735.3963
regina.olshan@skadden.com

Joseph M. Penko
Partner / New York
212.735.2618
joseph.penko@skadden.com

Erica Schohn
Partner / New York
212.735.2823
erica.schohn@skadden.com

Joseph M. Yaffe
Partner
650.470.4650 / Palo Alto
213.687.5516 / Los Angeles
joseph.yaffe@skadden.com

Michael R. Bergmann
Counsel / Washington, D.C.
202.371.7133
michael.bergmann@skadden.com

Stephanie Birndorf
Associate/ Palo Alto
650.470.3117
stephanie.birndorf@skadden.com

Ashley Marie Romanias
Associate / Washington, D.C.
202.371.7064
ashley.romanias@skadden.com