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Client Alert

ISS Issues FAQs and Burn Rate Benchmarks for 2019

EXEQUITY

Independent Board and Management Advisors

In November, ISS issued a set of preliminary Compensation FAQs. Then, on December 14, 2018, ISS issued its final set of Compensation FAQs for 2019, U.S. Compensation Policies, Frequently Asked Questions, Updated December 14, 2018. ISS then issued a set of updated FAQs for equity plans on December 19, 2018, U.S. Equity Compensation Plans, Frequently Asked Questions, Updated December 19, 2018.

U.S. Compensation FAQs

Below are the key questions and answers that were updated by ISS in this set of Compensation FAQs.

19. Any changes in the quantitative pay-for-performance (P4P) screens for 2019?

No, the quantitative P4P screens will remain the same for 2019.

Exequity Comment*: While ISS had indicated in its preliminary policies for 2019 that it wanted to revise the P4P quantitative analysis to utilize Economic Value Added (EVA) metrics in lieu of GAAP financial metrics as part of its Financial Performance Assessment (FPA), ISS ultimately decided not to implement that change for 2019. However, ISS did indicate that it will continue to study the use of EVA metrics and will report EVA metrics for companies in their 2019 ISS Proxy Reports.*

21. Does ISS prefer companies use TSR as an incentive program metric?

ISS does not endorse the use of TSR or any specific metric in executive incentive programs.

Exequity Comment*: While ISS avoids expressing an endorsement of TSR as a performance metric, the fact remains that if a company's compensation payouts are too far out of whack with its stock price performance, ISS' quantitative P4P assessment will be triggered which could lead ISS to issue a negative say-on-pay (SOP) vote recommendation.*

42. How does ISS analyze "front-loaded" awards intended to cover future years?

ISS is unlikely to support grants that cover more than four years (i.e., the grant year plus three future years) because such grants limit the board's ability to meaningfully adjust future pay opportunities in the event of unforeseen events or changes in either performance or strategic focus.

***Exequity Comment**: Any type of front-loaded equity grant will be met with additional scrutiny and skepticism from ISS. Therefore, companies that make such grants should clearly articulate the rationale for such grants, what is expected to be gained by making this grant, and the earliest possible time that regular annual grants will be resumed to individuals receiving such grants.*

47. Which problematic practices are most likely to result in an adverse recommendation?

The list includes:

- Repricing or replacing underwater stock options/SARs without shareholder approval.
- Extraordinary perquisites or tax gross-ups.
- New or materially amended agreements that provide for:
  - Excessive termination or change-in-control (CIC) severance payments.
  - CIC severance payments without involuntary job loss or substantial diminution of duties or in connection with a problematic "Good Reason" definition.
  - Problematic "Good Reason" termination definitions that present windfall risks, such as definitions triggered by potential performance failures.
  - CIC excise tax gross-up entitlements.
  - Multi-year guaranteed awards that are not at risk due to rigorous performance conditions.
  - Liberal CIC definition combined with any single-trigger CIC benefits.
- Insufficient executive compensation disclosure by externally managed issuers (EMIs) such that a reasonable assessment of pay programs and practices applicable to the EMI's executives is not possible.
- Any other provision or practice deemed to be egregious and present a significant risk to investors.

***Exequity Comment:** ISS added the bit about insufficient executive compensation disclosure by EMIs. So, this change will not have widespread impact. However, all EMIs should determine whether their disclosures would be "adequate" under the ISS guidelines in order to avoid a negative vote recommendation.*

48. How does ISS evaluate "Good Reason" termination definitions?

Such definitions should be limited to circumstances that are reasonably viewed as an adverse constructive termination and should be tailored to preclude potential windfall risk.

***Exequity Comment**: This is a completely new FAQ for 2019. It is good that ISS has finally provided some information on how it will evaluate "Good Reason" termination definitions. The examples ISS provided in this FAQ indicate that a "Good Reason" termination triggered by bankruptcy or delisting would be problematic.*

50. If a company becomes a "smaller reporting company" under the SEC's revised definition, how will ISS assess reduction in compensation disclosure?

Companies with scaled compensation disclosure requirements should continue to provide sufficient disclosure to enable investors to make an informed SOP vote; ISS typically wants the disclosure to be sufficient for it and investors to meaningfully assess the board's compensation philosophy and practices.

Exequity Comment*: ISS does not care that companies that now qualify as smaller reporting companies can now disclose less information in their proxy statements. If the company does not present enough information for ISS to assess the company's quantitative and qualitative P4P, even though such information likely is no longer required to be disclosed, ISS could issue a negative SOP vote recommendation.*

59. How would ISS view any compensation program changes made in light of the removal of 162(m) deductions?

Shifts away from performance-based compensation to discretionary or fixed pay elements will be viewed negatively.

Exequity Comment*: If companies move too far away from some of the Section 162(m) requirements (having pre-established goals set at the beginning of the performance period, not paying more than originally set as a maximum, etc.), they should expect some pushback from ISS.*

67. How does ISS apply its policy around "excessive" levels of non-employee director (NED) pay?

If a company has excessive NED pay without a compelling rationale in two or more years, it could cause ISS to recommend against directors. This policy will not be applied until February 1, 2020. If ISS identifies excessive NED pay at a company, it will undertake a qualitative review to determine if concerns are adequately mitigated. In evaluating a company's disclosed rationale, the following circumstances, if within reason and adequately explained, would typically mitigate concern around high NED pay:

- Onboarding grants for new directors that are clearly identified to be one-time in nature;
- Special payments related to corporate transactions or special circumstances; or
- Payments made in consideration of specialized scientific expertise.

ISS will evaluate payments made in connection with separate consulting agreements on a case-by-case basis. ISS will generally not view payments to reward general performance/service as compelling rationale.

Exequity Comment*: It is good that ISS released some information about the application of its policy. Also, it is good to see that ISS will treat certain groups of directors differently, i.e., newly appointed directors, those working on corporate transactions or special endeavors, and those with specialized scientific expertise. While stated in this FAQ, the next FAQ indicates that ISS will distinguish between regular board members and those holding leadership positions. Note that "leadership positions" are limited to just non-executive chairs/lead directors. Thus, this exception does not appear to be available to directors who serve as committee chairs.*

68. What is ISS' methodology to identify NED pay outliers?

ISS will compare individual NED total pay within the same index and sector. Directors will be compared to other directors within the same two-digit GICS group and within the same index grouping. Index groupings for purposes of this policy are: S&P 500, combined S&P 400 and S&P 600, remainder of the Russell 3000 Index, and the Russell 3000-Extended.

The methodology will also recognize board-level leadership positions, limited to non-executive chairs and lead independent directors, and individuals in these roles will be compared to others in the same role in their index and sector.

The methodology will also recognize cases where there is a narrow distribution of NED pay within a particular sector-index grouping, i.e., where there is not a pronounced difference between the top 2%–3% and the median director, this may be considered as a mitigating factor.

Exequity Comment: *The methodology ISS laid out makes sense, but the devil will be in the details. It certainly would be helpful if ISS published tables for high NED pay as it does for burn rates. If it did, companies could more easily get a sense of whether the pay of any of their NEDs needs further explanation in their proxies.*

U.S. Equity Compensation Plans FAQs

Below are the key questions and answers that ISS has updated with respect to this set of Equity Compensation Plans FAQs:

26. How will ISS treat plan proposals that are only seeking approval in order to qualify grants as "performance-based" under IRC Section 162(m)?

Proposals that only seek approval to ensure tax deductibility of awards pursuant to Section 162(m)—now under the "grandfather rule"—and that do not seek additional shares for grants or approval of any plan amendments, will generally receive a favorable recommendation regardless of Equity Plan Scorecard (EPSC) factors ("positive override"), provided that the board's compensation committee or other administering committee is 100% independent according to ISS standards.

Exequity Comment: *This is very close to ISS' prior policy of supporting Section 162(m)-only proposals that did not make material changes to the plan or add shares. The wrinkle here is the statement that the compensation committee must now be 100% independent. Since Section 162(m) is no longer a concern for most companies, except for grandfathered amounts, this policy may cause companies to not revise their compensation committee to include directors who are not viewed as "independent" by ISS, at least for the period that the grandfathered awards remain outstanding.*

27. How will ISS consider plan revisions relating to the 162(m) tax code changes?

Plan amendments that involve the removal of general references to 162(m) qualification will be viewed as administrative/neutral. But, if a plan contains provisions representing good governance practices, even if no longer required under the revised 162(m) code, their removal may be viewed as a negative change in a plan amendment evaluation.

Exequity Comment: *Again, peeling back too many of the Section 162(m) requirements, particularly the maximum limit of awards that may be granted to an individual, may cause a negative reaction from ISS.*

34. What changes were made to the EPSC policy for 2019?

Beginning February 1, 2019, the following updates will apply:

- The CIC vesting factor is updated to provide points based on the quality of disclosure of CIC vesting provisions, rather than based on the actual vesting treatment of awards. Full points will be earned if the plan discloses with specificity the CIC vesting treatment for both time- and performance-based awards. But no points will apply if the plan is silent on the CIC vesting treatment for either type of award or if the plan provides for merely discretionary vesting for either type of award.

- There is a new negative overriding factor for excessive dilution—greater than 20% for S&P 500 companies and greater than 25% for Russell 3000 companies (other than the S&P 500).

- Certain factor scores have been adjusted in accordance with ISS' proprietary (black box) scoring model.

Exequity Comment*: The most significant change is the addition of the excessive dilution override. While the dilution levels that trigger this new override are fairly high, companies in certain industries (e.g., biopharma, high-tech) are likely to flirt with such dilution levels. Also, companies that are in turnaround situations oftentimes have a significant amount of outstanding equity awards which add to a company's dilution. Companies in these situations would then be limited in the number of new shares that could pass the EPSC model (if any).*

45. When will excessive dilution have an adverse recommendation implication for the equity plan proposal?

Excessive dilution is an overriding factor that can be applied to S&P 500 and Russell 3000 companies. For S&P 500 companies, this override will be applied if dilution is greater than 20%. For Russell 3000 companies (excluding S&P 500), this override will be applied if dilution is greater than 25%. For this policy, ISS defines "dilution" as (A + B + C) / CSO, where A = number of new shares requested; B = number of shares that remain available for grant; C = number of unexercised/unvested outstanding equity awards; and CSO = common shares outstanding.

Exequity Comment*: ISS potentially will apply this new override to a large number of public companies—all Russell 3000 companies will be impacted. The level of dilution that triggers the override for the non-S&P 500 Russell 3000 companies covers a large group of companies with varying market capitalizations. The smaller-sized companies may find themselves bumping up against this dilution level a bit more than those with larger market capitalizations.*

2019 Burn Rate Benchmarks

See the Appendix to this Client Alert and the appendix of the U.S. Equity Compensation Plans FAQs for a full list of ISS' 2019 burn rate benchmarks for the S&P 500, Russell 3000 (excluding the S&P 500), and the non-Russell 3000.

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PUB/CA/ISS FAQs-2019 Burn Rate Benchmarks

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Appendix: 2019 Burn Rate Benchmarks

S&P 500

GICS	Description	Mean	Standard Deviation	Burn Rate Benchmark*
10	Energy	1.10%	0.55%	2.00%*
15	Materials	1.09%	0.66%	2.00%*
20	Industrials	1.28%	0.76%	2.04%
25	Consumer Discretionary	1.57%	1.13%	2.70%
30	Consumer Staples	1.08%	0.59%	2.00%*
35	Health Care	1.69%	0.79%	2.48%
40	Financials	1.78%	1.26%	3.04%
45	Information Technology	2.99%	1.59%	4.58%
50	Communication Services	1.50%	1.91%	3.41%
55	Utilities	0.65%	0.33%	2.00%*
60	Real Estate	2.16%	0.72%	2.88%

* The benchmark is generally the Mean + Standard Deviation, subject to minimum benchmark of 2%. In addition, year-over-year burn rate benchmark changes are limited to a maximum of two percentage points plus or minus the prior year's burn rate benchmark.

Russell 3000 (Excluding the S&P 500)

GICS	Description	Mean	Standard Deviation	Burn Rate Benchmark*
1010	Energy	2.39%	1.60%	3.99%
1510	Materials	1.69%	1.03%	2.72%
2010	Capital Goods	2.07%	1.68%	3.75%
2020	Commercial & Professional Services	2.39%	1.40%	3.80%
2030	Transportation	1.85%	1.54%	3.39%
2510	Automobiles & Components	1.95%	1.05%	3.00%
2520	Consumer Durables & Apparel	2.31%	1.50%	3.81%
2530	Consumer Services	2.88%	2.52%	5.41%
2550	Retailing	3.21%	2.92%	6.13%
3010	Food & Retailing Staples	1.95%	1.07%	3.03%
3020	Food, Beverage & Tobacco	1.56%	0.82%	2.38%
3030	Household & Personal Goods	2.39%	1.74%	4.13%
3510	Health Care Equipment & Services	3.91%	2.56%	6.48%
3520	Pharmaceuticals & Biotechnology	4.66%	2.31%	6.98%
4010	Banks	1.57%	1.25%	2.81%
4020	Diversified Financials	4.15%	4.43%	8.58%
4030	Insurance	1.89%	2.36%	4.26%
4510	Software & Services	5.75%	3.60%	9.35%
4520	Technology Hardware & Equipment	3.88%	2.53%	6.41%

GICS	Description	Mean	Standard Deviation	Burn Rate Benchmark*
4530	Semiconductor Equipment	4.49%	2.11%	6.61%
5010	Telecommunication Services	4.46%	5.52%	9.10%*
5020	Media & Entertainment	3.99%	3.41%	7.40%
5510	Utilities	1.08%	1.35%	2.43%
6010	Real Estate	1.29%	1.29%	2.58%

* The benchmark is generally the Mean + Standard Deviation, subject to minimum benchmark of 2%. In addition, year-over-year burn rate benchmark changes are limited to a maximum of two percentage points plus or minus the prior year's burn rate benchmark.

Non-Russell 3000

GICS	Description	Mean	Standard Deviation	Burn Rate Benchmark*
1010	Energy	2.88%	1.67%	4.55%
1510	Materials	2.90%	2.33%	5.23%
2010	Capital Goods	3.30%	3.03%	6.33%
2020	Commercial & Professional Services	4.69%	4.37%	9.06%
2030	Transportation	2.31%	1.44%	4.51%*
2510	Automobiles & Components	3.11%	2.47%	5.58%
2520	Consumer Durables & Apparel	2.99%	2.01%	5.00%
2530	Consumer Services	2.75%	2.14%	4.89%
2550	Retailing	4.31%	2.55%	6.86%
3010, 3020, 3030	Consumer Staples	4.96%	4.04%	9.00%+
3510	Health Care Equipment & Services	5.23%	3.41%	8.63%
3520	Pharmaceuticals & Biotechnology	6.23%	3.63%	9.86%
4010, 4020, 4030	Financials	2.41%	2.70%	5.11%+
4510	Software & Services	5.69%	3.56%	9.24%
4520	Technology Hardware & Equipment	4.58%	3.29%	7.87%
4530	Semiconductor Equipment	4.32%	2.31%	6.63%
5010, 5020	Telecom & Media	4.18%	3.31%	8.08%*+
5510	Utilities	1.59%	1.18%	2.83%*
6010	Real Estate	1.50%	1.51%	3.07%*

* The benchmark is generally the Mean + Standard Deviation, subject to minimum benchmark of 2%. In addition, year-over-year burn rate benchmark changes are limited to a maximum of two percentage points plus or minus the prior year's burn rate benchmark. The industry is subject to this limit.

+ Benchmark based on all companies in the 2-digit GICS average due to insufficient number of companies to analyze within the 4-digit GICS industry.

Source: ISS' U.S. Equity Compensation Plans, Frequently Asked Questions, Updated December 19, 2018.