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EXEQUITY

Independent Board and Management Advisors

Client Alert

ISS Releases Policy Updates for 2019

On November 19, 2018, ISS released its policy updates for the 2019 proxy season.[1] Then on November 21, 2018, ISS issued a set of preliminary FAQs on Compensation Policies for 2019. These policy updates and FAQs will apply to shareholder meetings on and after February 1, 2019.

2019 Policy Updates

The 2019 Policy Updates did not include any changes to ISS' compensation policies for 2019. However, ISS did indicate that it will feature EVA (economic value added) metrics in its proxy reports for U.S. and Canadian companies on a phased-in basis over 2019. But ISS will continue to use GAAP measures in its quantitative pay-for-performance (P4P) test's Financial Performance Assessment (FPA) during 2019. ISS also made clear that it intends to continue studying how to bring EVA metrics into its quantitative P4P assessment, as it received favorable feedback from clients agreeing with the direction ISS was taking in this regard to the assessment of financial performance of companies. Investors also indicated they wanted additional time to understand the proposed EVA methodology better and its potential to add insight to ISS' quantitative P4P analysis.

For director elections, ISS will make a change with respect to board gender diversity. For U.S. companies, ISS announced a new policy taking effect **February 1, 2020** with respect to companies in the Russell 3000 or S&P 1500 indexes that do not have any women on their boards. ISS may issue adverse voting recommendations at such companies with respect to the chairs of nominating committees and, on a case-by-case basis, with respect to other directors who are responsible for the board nomination process. The policy allows the absence of board gender diversity to be temporarily explained and excused.

Preliminary 2019 Compensation FAQs

The key points from the preliminary FAQs are:

- **Quantitative P4P Screen**: Confirmation that ISS will not make any changes to its quantitative P4P screens for 2019.

- **"Excessive" Non-Employee Director (NED) Pay**: ISS will not begin applying the "excessive pay" policy concerning NED pay until 2020 (instead of the originally announced 2019), as it intends to provide more details on the methodology it employs in identifying NED pay outliers.

[1] The ISS 2019 Policy Updates and the U.S. Preliminary Compensation FAQ can be found at: https://www.issgovernance.com/policy-gateway/latest-policies/.

- **Equity Plan Score Card (EPSC) Scoring**: EPSC scoring thresholds will remain the same as in 2018:
  - Threshold for **S&P 500 companies**: 55 points (out of 100 possible).
  - Threshold for **all other companies**: 53 points (out of 100 possible).
- **EPSC "Overriding" Factors**: ISS will now include ***excessive dilution (simple dilution)*** as an overriding factor that will cause it to recommend against equity plan proposals, regardless of whether they score above the applicable EPSC scoring threshold. The dilution levels that will trigger this new override are:
  - For **S&P 500 companies**, dilution that is ***greater than 20 percent***.
  - For **Russell 3000 companies**, dilution that is ***greater than 25 percent***.

    Note: *ISS defines dilution for this purpose as (A + B + C) / CSO, where A = number of new shares requested; B = number of shares that remain available for issuance under continuing plans; C = number of unexercised/unvested outstanding equity awards; and CSO = common shares outstanding.*
- **EPSC Model's Change-in-Control (CIC) Factor**: The CIC factor under the EPSC model will be updated to evaluate the quality of disclosure of CIC vesting provisions, rather than be based on the actual vesting treatment of awards as was previously the case. Full points under the CIC factor will require the equity plan to disclose with specificity the CIC vesting treatment for both performance- and time-based awards. If the plan is silent on the CIC vesting treatment for either type of award, or if the plan provides for merely discretionary vesting of either type of award, then no points will be earned for the CIC factor under the EPSC model.

As these FAQs were designated "preliminary," it is possible that ISS could revise them before it begins applying its policies for the 2019 proxy season, i.e., for shareholder meetings on and after February 1, 2019. Therefore, if you seek to rely on any of these FAQs, be sure to keep a close watch for the "final" compensation FAQs that ISS should issue before the end of January 2019 to determine if any changes in your approach might be necessary.

Conclusion

While ISS did not announce any significant new compensation policies for 2019, the delay of the application of its excessive NED pay policy is welcome and should lead to ISS providing additional details on how it will go about applying this policy.

For companies taking an equity plan proposal to shareholders in 2019, be aware of the introduction of the new excessive dilution override. This new override should not present an issue for most companies. However, it could prove problematic for companies in certain industries that utilize equity awards more heavily than other industries, e.g., high-tech and bio-pharma industries.

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