

ISS Updates FAQs on US Compensation Policies

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ISS released its annual update of frequently asked questions on its US Compensation Policies on December 20, 2018 (preliminary updates had been released in November). The updates are effective for shareholder meetings occurring on or after February 1, 2019. There are nine new or materially updated questions, which are summarized below:

- **#19 Will any of the quantitative pay-for-performance screens change in 2019?** No. The screens will continue to use GAAP/accounting performance measures, but ISS will display Economic Value Added (EVA) measures on a phased-in basis over the 2019 proxy season and will continue to explore their future use to add insight to financial performance. (EVA can measure a company's residual wealth by deducting its cost of capital from its operating profit, adjusted for taxes on a cash basis.)
- **#21 Given the use of TSR in ISS' quantitative screen, does ISS prefer companies use TSR as an incentive program metric?** While it recognizes investors' preference for objective and transparent metrics, ISS does not endorse or prefer the use of total shareholder return (TSR) or any specific metric in executive incentive programs.
- **#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 (ie, the grant date plus three future years), and for these types of grants, commitments not to grant additional awards over the covered period should be firm. Usual pay-for-performance considerations will be more closely scrutinized.
- **#47 Which problematic practices are mostly likely to result in an adverse recommendation?** Additional problematic pay practices that are likely to result in adverse vote recommendations on compensation committee members and/or say on pay proposals now include: (1) excessive termination payments (not just change in control payments) exceeding three times base pay and annual bonus, and (2) a "good reason" termination definition that presents windfall risks.
- **#48 How does ISS evaluate "Good Reason" termination definitions?** ISS will scrutinize "Good Reason" definitions to ensure that the circumstances are reasonably viewed as an adverse constructive termination, and to determine whether there is a potential windfall risk. Circumstances reflecting potential performance failures, such as bankruptcy or delisting, will be considered problematic.
- **#50 If a company becomes a "smaller reporting company" under the SEC's revised definition, how will ISS assess reduction in compensation disclosure?**

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ISS notes that smaller reporting companies (SRCs) are still required to hold say on pay votes, and so while they may use scaled compensation disclosure requirements, SRCs should continue to provide sufficient disclosure to enable investors to make an informed say on pay vote. This means that SRCs should think carefully before eliminating CD&As, and at minimum, ensure that there is sufficient narrative for shareholders to meaningfully assess compensation philosophy and practices.

- **#59 How would ISS view any compensation program changes made in light of the removal of 162(m) deductions?** While shifts away from performance-based compensation to discretionary or fixed pay elements did not make the list of problematic pay practices most likely to result in an adverse recommendation, ISS will still consider these shifts to be problematic pay practices and will view them negatively.
- **#67 How does ISS apply its policy around "excessive" levels of non-employee director pay?** If ISS determines that a NED's pay is a quantitative pay outlier (see FAQ below), it will perform a qualitative evaluation of the company's disclosed rationale to determine if concerns are adequately mitigated. The updated FAQs list a number of circumstances that will typically mitigate concern around high non-employee director (NED) pay, including onboarding grants, special payments related to corporate transactions or special circumstances, and payments for specialized scientific expertise as may be necessary in certain industries. As a reminder, last year, ISS had announced a policy to recommend against board members responsible for approving NED pay when there is a recurring pattern of excessive pay magnitude without a compelling rationale in two or more consecutive years. ISS subsequently updated its methodology to identify pay outliers, and in consideration of the updates, ISS had postponed issuing adverse recommendations until meetings occurring on or after February 1, 2020.
- **#68 What is ISS' methodology to identify non-employee director pay outliers?** The updated FAQs clarify that the methodology identifies pay outliers above the top 2-3% (vs the top 5%) of all comparable directors within the same two-digit GICS group and index grouping (eg, S&P 500). The revised methodology acknowledges that there are pay premiums for non-executive chairs and lead independent directors, and in limited instances, the methodology also makes allowances for narrow distributions of NED pay, where there is not a pronounced difference in pay between the top 2-3% of directors and the median director.