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New FAQs from ISS Clarify Upcoming Compensation Policy Changes for 2018

The latest FAQs from ISS explain how the proxy advisory firm will implement changes to its CEO pay-for-performance analyses and apply its new Equity Plan Scorecard methodoogy.

Institutional Shareholder Services (ISS) recently published **preliminary Compensation FAQs** for the United States (US) that address how the proxy advisory firm will implement compensation-related changes to its 2018 policy voting recommendations. To catch-up on the full list of policy changes ISS is making in the US market next year, see our recent **client alert**.

The two biggest compensation-related changes ISS is making next year (aside from a director pay policy, which goes into effect in 2019) include adding a secondary quantitative filter under the CEO Pay-for-Performance Policy and a new policy application for the Equity Plan Scorecard (EPSC).

Consistent with prior years, the FAQs provide fairly significant policy changes. We expect additional clarification throughout the remainder of this year and during the 2018 proxy season, through additional FAQs and an updated white paper on the CEO Pay-for-Performance Policy.

Summarized below are the relevant Pay-for-Performance Policy and EPSC Policy FAQs:

CEO Pay-for-Performance

- **Multiple of Median component of Quantitative Analysis:** For S&P 500 companies, the threshold for a “medium” level of concern will be reduced to 2.00 times the median pay of the peer companies, from 2.33 previously.

- **TSR Calculation:** ISS will now smooth beginning and ending stock prices used in calculating TSR for a period by taking the average of the beginning and ending stock prices for the applicable month. Dividends and splits will be factored in.

- **Use of Supplemental Metrics in Financial Performance Assessment:** After ISS has run its three existing quantitative tests (Relative Degree of Alignment, Multiple of Median, and Pay TSR Alignment), the relative pay and performance metrics (“Financial Performance Assessment”) will be used as a secondary screen. If a company has a “medium” concern on the primary screens, but relatively strong performance on these performance metrics, ISS might reduce the final level of quantitative concern to “low.” However, if a company has “low” concern but its relative performance metrics are relatively weak,

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ISS might increase the final level to “medium.” The FAQs also include a chart with the financial metrics for the various GICS groups that will be used to calculate the new analysis, with the final weightings yet to be disclosed at this point. Companies will now potentially be assessed under this new test against up to four financial performance metrics, as opposed to the maximum seven financial performance metrics used in 2017.

Our Thinking: The lowering of the medium scoring threshold for the Multiple of Median test from multiples of 2.33 to 2.00 for S&P 500 index sized firms and the application of the secondary analysis to those companies finishing with borderline low/medium level scores under the primary quantitative filters may result in more qualitative assessments under the CEO Pay-for-Performance Policy during the 2018 proxy season. However, the smoothing of the TSR calculation and the use of the FPA may offset some of the negative implications of the new policy applications for the 2018 proxy season. Further clarification on this policy for 2018 is expected in a final ISS white paper and additional FAQs.

Equity Plan Scorecard

- **Passing Score Change for S&P 500 Companies:** The passing score for S&P 500 companies will now be 55 points. For all other companies, it will remain at 53.
- **Change-in-Control Vesting:** The ISS scorecard will now give full credit only if an equity plan change-in-control vesting provision contains both performance-based awards (equity awards are accelerated and the participant’s payout is limited to actual performance achieved or the performance awards are forfeited) and time-based awards (equity awards are not accelerated based on a single trigger or discretion). In all other cases, an equity plan will receive no credit.
- **Holding Period:** An equity plan will now receive full credit for a holding period of 12 months or until the end of employment, which is a reduction from the previous level of 36 months. A plan with a holding period of less than 12 months, or only until ownership guidelines are met, will receive no credit.
- **CEO Vesting Requirement:** An equity plan will now receive full credit if the vesting of time-based options, time-based restricted stock and performance-based equity is at least three years from the date of grant, down from four years previously. Vesting of less than three years on any of such vehicles will result in no credit.
- **Board Discretion to Accelerate Vesting:** An equity plan will only receive full credit if board discretion to accelerate vesting is limited solely to cases of death or disability. Authority to accelerate in the case of a change of control will now not receive any credit.

Our Thinking: The new FAQs seem an attempt to simplify what many external observers have categorized as an overly complicated assessment for share requests. The increased passing score for S&P 500 companies and the simplified inputs noted above may result in companies needing to adopt more ISS-deemed best practice plan features and/or grant practices to receive ISS support for a share request. However, given that historically only a small number of companies fail to obtain majority approval of share requests each year, we caution that companies should analyze their top investor base to determine the extent to which compliance with ISS policies is necessary or desirable— especially if the adoption of numerous (if not all) ISS-deemed best practices are required to obtain a short share pool duration.

Next Steps

While these FAQs are insightful, we expect more fulsome clarification on these policies and others through the publication of additional final FAQs and a white paper on the CEO Pay-for-Performance Policy. As such, much of this guidance is preliminary at this point. If you have any questions about these policy updates or want to speak to a member of our consulting team about related compensation and governance issues, please write to consulting@radford.com.

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