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ISS Policy Changes for 2018 Put More Scrutiny on CEO Pay-for-Performance and Director Pay

New ISS policy updates add another layer of review to CEO pay-for-performance analyses, put more scrutiny on director pay and address disclosures related to gender pay equity.

Institutional Shareholder Services (ISS) announced its **2018 policy updates** on November 11, 2017, setting the stage for new approaches to evaluating companies' compensation and governance policies and related shareholder resolutions. These changes are effective for shareholder meetings taking place on or after February 1, 2018, except where noted with the director pay policy.

Consistent with prior years, the 2018 policy updates include amended and new policies, as well as provide clarification on existing policies. ISS provided further clarification on these new policies in the form of preliminary compensation FAQs. Read our alert clarifying how ISS will implement several of the following compensation policy updates **here**.

Summarized below are a few of the key compensation and general governance-related policy changes applicable in the United States for 2018.

Compensation-Related Policy Updates

- **CEO Pay-for-Performance Policy:** ISS' quantitative assessment within this policy now includes a relative assessment of a company's three-year CEO pay percent rank as compared to a three-year financial performance percent rank. This will likely be assessed using some of the measures in ISS' "Relative Pay and Financial Performance Scorecard" introduced last year. (ISS plans on decreasing the measures under this analysis to only three or four, depending on industry, compared to seven measures in previous years.) This test appears to be in addition to the existing three quantitative tests, which currently include the Relative Degree of Alignment test (which measures a company's three-year CEO pay percent rank relative to three-year TSR performance of a group of ISS-selected peers), the Multiple of Median (which measures a company's current year CEO pay relative to the median CEO pay of the ISS-selected peers), and the Absolute Pay TSR Alignment test (which measures the spread between the rate of pay change relative to indexed TSR performance over a five-year time period).
    - **Our thoughts:** This new test appears related to the "Relative Pay and Financial Performance Scorecard" information contained for the first time in ISS reports during the 2017 proxy season. However, details regarding the applicable financial metrics, weightings and scoring thresholds for this new test have not yet been released. Based on initial communications from ISS' research

team at recent public events, there is speculation that this new test will be used as a secondary quantitative filter for a limited number of companies scoring poorly on one or both of the other two relative quantitative tests. We expect the forthcoming FAQs to provide more information about the application of this new test, including when it applies and which metrics will be used.

- **Non-Employee Director Compensation Policy:** Starting in the 2019 proxy season, ISS will recommend against the re-election of board members responsible for approving/setting non-executive director compensation where there is a recurring pattern (i.e., two or more consecutive years) of excessive director pay without a compelling rationale or other mitigating factors. Note, ISS' research team has stated this particular policy update will not impact vote recommendations for 2018.

  - **Our thoughts:** The increased focus by ISS on director pay is not wholly unexpected, as ISS has been assessing director pay as a multiple of median (relative to the pay-for-performance peers) over the past few years. We expect more detail about what is considered "excessive" pay and what will be considered "mitigating" measures for potentially excessive pay concerns in forthcoming FAQs.

Governance-Related Policy Updates

- **Gender Pay Gap Reporting:** Over the past three years, there has been a rise in shareholder proposals requesting companies report whether a gender pay gap exists, and if so, what measures they are taking to address it. ISS is adopting a new case-by-case policy to address their voting policy for these proposals. The new policy will examine 1) a company's policies and disclosures on diversity and inclusion, and whether disclosure lags its peers; 2) a company's compensation philosophy and use of fair and equitable practices; and 3) whether a company has been the subject of any recent controversies, litigation, or regulatory actions related to gender pay gap issues.

  - **Our thoughts:** This policy is, in many ways, the codification of the unofficial qualitative approach that ISS has been informally taking over the past few proxy seasons when evaluating gender pay gap proposals. This policy highlights a growing need for companies to proactively disclose gender pay related policies in corporate governance documents and in proxy disclosure to avoid adverse vote recommendations from proxy advisors on such shareholder proposals. Additionally, given shareholders' increased focus on environmental, social and governance (ESG)-related issues, companies should start considering whether their existing policies (if any formally exist) are adequate and communicated externally in an effective manner.

- **Board Diversity:** ISS will formally highlight boards lacking gender diversity. However, this information will not be used to make voting recommendations in 2018.

  - **Our thoughts:** Many investors are calling for increased gender diversity on boards. Companies should ensure that their proxy disclosure adequately explains any existing board diversity policies, especially if there is a lack of diversity on the existing board (i.e., how diversity is considered when assessing current and prospective board members). This is particularly relevant if there hasn't been a lot of board turnover in recent years.

- **Poor Attendance:** ISS will no longer issue negative vote recommendations for new directors who serve on the board for only part of the year.

    - **Our thoughts:** This policy clarification will help to ensure that companies and applicable directors are not penalized with negative vote recommendations for attendance issues that can arise due to mid-year board transitions.

- **Climate Change Risk Proposal Evaluations:** ISS is formally expanding the factors that will cause it to support shareholder proposals seeking disclosure of climate change risks. Not only will ISS look at a company's existing disclosure of the financial, physical and regulatory risks a company faces, but also of the company's process for identifying, measuring, and managing those risks.

    - **Our thoughts:** Similar to ISS' perspective on other shareholder proposals, ISS is looking for increased disclosure regarding company and board practices for identifying and managing this risk. For many companies that already have such processes in place, ISS and others will be looking for enhanced disclosure of how the issue is handled by the company as a key mitigating factor in evaluating whether or not to support an applicable shareholder proposal.

- **Long-Term Poison Pills:** An active poison pill that was enacted without shareholder approval with a duration of more than one year (whether a new or legacy pill) will result in automatic "against" recommendation from ISS on all of a company's directors every year, regardless of whether the board is classified or elected annually. Pills adopted in 2009 and earlier, which had been grandfathered under the existing policy, will no longer be exempt from negative recommendations.

    - **Our thoughts:** This change in policy will likely result in negative vote recommendations for numerous companies that were exempt from a full ISS review on this matter in previous years. Companies with legacy pills should evaluate their risks for a possible negative vote recommendation, and determine the extent to which their top shareholders may follow an ISS recommendation on this matter. ISS' intent to recommend against directors who might not even be on the ballot is evidence of its strong views of such pills.

- **Short-Term Poison Pills:** Pills that are effective for one year or less that were not approved by shareholders will continue to receive a case-by-case evaluation by ISS, with more focus on the company's rationale for the unilateral adoption.

    - **Our thoughts:** Similar to ISS' stance on other unilateral actions taken by the board, disclosure of a compelling mitigating rationale is required to avoid negative vote recommendations on applicable board nominees. However, ISS has not yet published what types of rationale would be required to avoid a negative recommendation.

ISS Clarification on Existing Policies

- Pledging of company shares is evaluated on a case-by-case basis, examining its magnitude and rationale, and efforts to wind it down.

- Say-on-pay frequency proposals must be on the ballot when required by regulation to avoid negative director recommendations.

- Special purpose acquisition company extension proposals are examined on the basis of the length of the request, any pending transactions, any equity kicker, and prior extension requests.

- State laws that mandate classified boards are a basis for perennial negative director recommendations unless the company has opted out of those laws.

Next Steps

While the new 2018 ISS policy updates contain numerous provisions that will impact boards of directors and executives, there is still uncertainty about their final application in the 2018 proxy season. As such, we expect to see more detailed explanations regarding these updates in the FAQs (and possibly in white papers), which are typically published in the mid-to-late December timeframe. Companies should remember that there is also a chance that ISS could provide additional clarifications or methodology changes for other policies, such as the Equity Plan Scorecard.

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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