EXECUTIVE COMPENSATION AND CORPORATE GOVERNANCE CLIENT ALERT

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ISS Releases Policy Changes for the 2018 Proxy Season

Institutional Shareholder Services ("ISS") recently released its policy updates for its 2018 proxy voting guidelines, effective for meetings on or after February 1, 2018. Meaningful changes have been made to the ISS Pay-for-Performance Quantitative Evaluation of CEO pay, and a new policy was added to evaluate if non-employee director pay is "excessive." Below is a summary of the key changes.

Key ISS Policy Changes

- **CEO Pay-for-Performance Evaluation** – The quantitative evaluation by ISS will include a new financial assessment based upon return metrics and, depending on the industry, operational growth metrics. The Financial Performance Assessment ("FPA"), as it has been labeled, may modify the results generated under the historical total shareholder return ("TSR")-based screening and may change a company's concern level from a Medium to Low or from a Low to Medium (will not have any impact on the High concern level, positively or negatively).
- **Director Compensation** – ISS will be identifying companies with non-employee director compensation near or at the top of their respective industry and may issue an Against voting recommendation for compensation committee members if non-employee director pay (as a group or by individual) is identified as "excessive" for multiple years in a row (i.e., two or more consecutive years; meaning the first Against recommendation could potentially occur in the 2019 proxy statement).

Pay-for-Performance Evaluation

As part of the process for issuing say-on-pay voting recommendations, ISS reviews a company's compensation program by evaluating the alignment between the CEO's pay and the company's performance (as well as an assessment of certain qualitative factors). The CEO pay-for-performance evaluation (or the quantitative assessment) has historically only compared CEO pay to the company's absolute and relative TSR performance using three specific tests. The new fourth test (FPA), will measure CEO pay relative to financial performance, based upon three or four financial metrics over a three-year period, on a comparative basis to the ISS-developed peer group. The FPA will serve as a "secondary measure" with the new quantitative screening methodology working as follows:

- The three "primary" TSR-based tests will result in an Initial Quantitative Concern level.
- The "secondary" modifying effect of the FPA will only be applied if a company's Initial Quantitative Concern results in a Medium or Low Concern that nears the Medium Concern threshold. The modifying effect of the FPA, (if any, on the Initial Quantitative Concern will result in the Overall Quantitative Concern Level. The

modifying effect of the FPA may cause companies with relatively poor fundamental financial performance to move from a Low Concern to a Medium Concern level, while companies with relatively strong fundamental financial performance may shift from a Medium Concern to a Low Concern level.

- The FPA results will not impact companies with a High Concern level or Low Concern that is below ISS-stated thresholds to be eligible for an FPA adjustment.

The FPA selects and weights metrics for each industry slightly differently.

- For real estate companies in the 6010 GICS code, the following metrics will be used (listed from highest to lowest weighting):
  - Return on invested capital (ROIC)
  - Return on assets (ROA)
  - Return on equity (ROE)
  - Operating cash flow growth
- For finance REITs in the 4020 GICS code, the operating cash flow growth will not be used.

Non-Employee Director Compensation

ISS has developed a new policy related to the magnitude of non-employee director pay: ISS will generally vote against members of the board committee responsible for approving/setting non-employee director compensation if there is a pattern (i.e., two or more years) of "excessive" non-employee director compensation without disclosing a compelling rationale or other mitigating factors. Accordingly, as a result of this new policy, the first negative voting recommendation would not result until the 2019 proxy season. ISS has provided the following additional information on this new policy:

- "Excessive" pay will be identified on a director-by-director basis – meaning one outlier can trigger an adverse voting recommendation. It is unclear if ISS will aggregate all directors into the same pay analysis, including those in leadership roles such as the chairperson or lead director (which could have distortive results due to the fact that many chairs receive large additional retainers for serving in this capacity).
- ISS indicated "extreme outliers" will generally be defined as the top 5% of comparable directors in the same index and industry (which, for Russell 3000 companies, was approximately $280,000 in total director compensation based on 2017 proxy statements).

Updates Only Applicable to S&P 500 Companies

Due to increased scrutiny at large-cap companies, ISS has adjusted certain thresholds to distinguish S&P 500 companies from others for the 2018 proxy season, including:

- Lowered the Medium Concern threshold for the Multiple of Median test from 2.33x to 2.00x
- Increased the necessary points under the ISS Equity Plan Scorecard from 53 points to 55 points to receive a For voting recommendation on an equity plan proposal (which gives public companies the ability to award equity to employees and directors for compensation purposes)

Other Compensation Updates

- **Clarification of Say-on-Pay Responsiveness**: ISS' updated policy provides new requirements in evaluating a board's response to a low vote result (i.e., less than 70% support) to include disclosing: (i) engagement efforts with institutional investors, including timing, frequency and participation of independent directors; (ii) the concerns of the dissenting shareholders, and (iii) meaningful actions taken to mitigate concerns.
- **CEO Pay Ratio**: Beginning in 2018, ISS reports will display the CEO pay ratio and median employee pay figure for companies required to disclose, but ISS vote recommendations will not be impacted.
- **TSR Calculation**: TSR for the Relative Degree of Alignment test will use the average close price for the first and last months of the measurement period (previously used the December 31st spot price).
- **Problematic Pay Practices**: ISS' updated problematic pay practices list now includes new/extended executive agreements (e.g., employment, severance) if they include both (i) a liberal change-in-control ("CIC") definition (such as a very low buyout threshold or a CIC occurring upon shareholder approval of a transaction, rather than its consummation) and (ii) automatic full vesting of equity awards upon a CIC (i.e., single trigger). Previously, the concept of a liberal CIC definition was only assessed in connection with an equity plan proposal.

Governance Updates

- **Poison Pills**: ISS will recommend against all board nominees every year a company maintains a long-term poison pill (greater than one year) not approved by public shareholders. Approval prior to becoming public is insufficient, and **grandfathered pills will no longer be exempt.**
- **Gender Diversity**: In 2018, ISS will identify companies with a lack of board gender diversity. Although vote recommendations will not be impacted, FTI Consulting notes that this is often the precursor to a formal policy that may impact vote recommendations in the near future.
- **Pledging**: ISS established an explicit policy to vote against the committee responsible or the full board for significant pledging of company stock notwithstanding certain extenuating factors.

FTI CONSULTING™

Larry Portal
973.852.8147
larry.portal@fticonsulting.com

Katie Gaynor
704.972.4145
katie.gaynor@fticonsulting.com

Jarret Sues
973.852.8109
jarret.sues@fticonsulting.com