EXECUTIVE COMPENSATION AND CORPORATE GOVERNANCE ALERT

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ISS Releases Policy Changes for the 2019 Proxy Season

Institutional Shareholder Services ("ISS") recently released its policy updates for its 2019 proxy voting guidelines, effective for meetings on or after February 1, 2019. Below is a summary of the key changes.

Key ISS Policy Changes

- **Board Gender Diversity (New Policy)** – Beginning in 2018, ISS began noting companies whose boards lacked gender diversity, however ISS did not issue any adverse voting recommendations as a result. Beginning in 2020 (one year grace period), ISS will begin issuing adverse voting recommendations against the nominating committee chairperson, as well as potentially against other members of the nominating committee, for boards that have no female directors. Exceptions to the adverse voting recommendation may be made in exceptional circumstances where the absence of gender diversity could be temporarily explained and/or excused. This policy applies ONLY to companies in either the Russell 3000 or S&P 1500 Indices.
- **Director Compensation (Policy Update)** – In 2018, ISS began identifying companies with non-employee director compensation near or at the top of their respective industry and stated they 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). ISS has delayed the implementation of this new policy pending a revised methodology for identifying outliers. As a result, 2020 will be the first year in which an Against recommendations could be issued.

Board of Directors Composition (Gender Diversity)

In recent proxy seasons, investors have noted boards with little or no female representation and emphasized the need for increased diversity, citing reasons of equality, good corporate governance and enhanced long-term performance. As a result, many boards have added women directors in recent years. In the last two years, some large investors have cast votes against directors of companies whose boards have not added female representation.

In alignment with this trend, ISS will generally recommend a vote against the chair of the nominating committee (as well as the other nominating committee members on a case by case basis) if there are no women on the board for all companies in the Russell 3000 or S&P 1500 Indices beginning in 2020. Exceptions may be made if the company has stated a firm commitment (in the proxy statement) to appoint at least one female to the board in the near term, if there was a female on the board at the preceding annual meeting or select other relevant factors.

While not an ISS requirement, the State of California recently enacted legislation that requires at least one female director by the end of 2019 and at least two or three (depending on Board size) by the end of 2021.

Non-Employee Director Compensation

In 2018, ISS instituted 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. After feedback, ISS decided to revise their methodology to identify outliers and delay the first voting recommendation related to this policy until the 2020 proxy season (instead of 2019).

ISS will be providing clarity in December 2018 on their non-employee director "excessive" pay methodology, original methodology outlined below:

- "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).

Other Compensation Updates

- **Pay-for-Performance Evaluation**: ISS introduced the Financial Performance Assessment ("FPA") into their pay-for-performance evaluation process beginning in 2018 proxy season. The FPA acts as a secondary relative performance screening based upon certain GAAP measures, including return on invested capital, return on assets, return on equity and/or operating cash flow growth (depending on the industry) that 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).

  ISS explored using economic value added ("EVA") metrics to replace the GAAP-based financial measures. Following investor feedback for more time to fully understand the EVA methodology, ISS ultimately decided not to include EVA measures in 2019 and will continue to only use the GAAP measures in the FPA assessment. Although the 2019 FPA remains unchanged, ISS stated that they will continue to explore the potential use of EVA in future proxy seasons.

- **Equity Plan Scorecard (Equity Upsizing):** ISS has added a new "overriding" factor that will be considered when reviewing Equity Plan proposals. If the plan is deemed excessively dilutive (estimated to dilute shareholders' holdings by more than 20% (for S&P 500 companies) or 25% (for Russell 3000 companies), ISS will automatically issue an Against recommendation. The new factor will only impact S&P 500 and Russell 3000 companies.

  Additionally, ISS will adjust the Equity Plan Scorecard with respect to the change in control vesting factor, so that points will now be provided based on the quality of disclosure for change in control vesting provisions, rather than based on the actual treatment of the awards. If the plan is silent on the change in control vesting for either time- or performance-based awards, or if the plan provides for discretionary vesting of either, no points will be earned.

Governance Updates

- **Director Attendance:** ISS will vote against or withhold from members of the nominating or governance committees in the event director(s) have chronic poor attendance without explanation, in addition to the director themselves. Chronic poor attendance is defined as three or more consecutive years of poor attendance (less than 75% of the aggregate board and committee meetings) without reasonable explanation. After three years of poor attendance, ISS will recommend withhold for the chair of the nominating or governance committee. After four years of poor attendance, ISS will recommend withhold for the entire nominating or governance committee. After five years, ISS will recommend withhold for all board nominees.

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The Executive Compensation and Corporate Governance practice at FTI Consulting has the unique capability to advise clients on both complex and routine compensation and other strategic matters. Our team of professionals has experience providing practical guidance on deal structuring, tax structuring, value-add governance changes and implementing compensation programs that are aligned with each company's strategic plan and reward employees for creating tangible value.

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