

2017 Proxy Season: Key ISS Compensation-Related Updates

Companies should consider compensation-related changes to ISS policies when preparing for annual meetings on or after February 1, 2017.

Institutional Shareholder Services (ISS) recently released updates to its 2017 voting policies effective for annual meetings on or after February 1, 2017. This *Client Alert* summarizes compensation-related policy changes and updates that companies should consider going into the 2017 proxy season.

Updated Pay-For-Performance Evaluation – Addition of Relative Pay and Financial Performance Assessment

As most readers are aware, pay-for-performance is a primary area evaluated by ISS when issuing its voting recommendations on “say-on-pay.” Pay-for-performance may also impact ISS’ voting recommendations regarding director elections and, under certain circumstances, equity compensation plan proposals.

Background – Pay-for-Performance

The pay-for-performance evaluation involves both quantitative and qualitative assessments. The quantitative assessment considers:

- Relative Degree of Alignment, which measures the alignment of a company’s CEO compensation and total shareholder return (TSR) over a three-year period relative to an ISS-defined peer group
- Multiple of Median, which expresses a company’s CEO compensation as a multiple of the median CEO compensation of an ISS-defined peer group
- Pay-TSR Alignment, which measures the absolute alignment of a company’s CEO compensation and TSR over a five-year period

If the results of the quantitative assessment indicate an apparent disconnect between CEO compensation and company performance, and in certain other circumstances (for example, if the prior say-on-pay proposal received substantial shareholder opposition), ISS will conduct a more in-depth qualitative review designed to uncover the likely cause of the apparent disconnect, or factors that mitigate the findings of the initial assessment. The results of the quantitative and qualitative assessments are presented and discussed in ISS’ proxy research report.

New Assessment – Relative Pay and Financial Performance

ISS announced the addition of a new “Relative Pay and Financial Performance Assessment” in its 2017 voting policy updates, which will analyze a company’s long-term CEO compensation and financial

performance rankings relative to the company's ISS-defined peer group. Beginning in 2017, this assessment will be used as part of ISS' qualitative review and will be included in research reports for all companies subject to the quantitative assessment.¹

The Relative Pay and Financial Performance Assessment will analyze a company's financial and operational performance over a two- or three-year period (depending on trading history and data availability) across a set of weighted metrics that include TSR, plus up to six of the following additional metrics:

- Return on invested capital
- Return on assets
- Return on equity
- EBITDA growth
- Cash flow (from operations) growth
- Revenue growth

The applicable metrics and their relative weights will vary based on a company's Global Industry Classification Standard (GICS) industry group, and will be measured using data from the 12 most recent trailing quarters (or for growth metrics, the 16 most recent trailing quarters) as of ISS' latest Quarterly Data Download from Compustat.

Companies are ranked against their ISS-defined peers across each of the applicable metrics. The metric performance ranks are then combined into a weighted average performance rank, which is compared to the company's CEO pay rank. The numeric score indicating the alignment between the company's weighted average performance rank and its CEO pay rank will be presented in the company's ISS research report (together with a comparison against companies within the applicable GICS industry group that received the same level of concern under the quantitative analysis), and may impact ISS' qualitative assessment. The addition of the six additional financial performance criteria is intended to reduce the reliance on TSR as the measure of a company's financial performance.

Equity Plan Scorecard Analysis

ISS utilizes its Equity Plan Scorecard (EPSC) to evaluate proposals to approve or amend certain equity-based compensation plans. Under the EPSC, ISS considers a range of weighted factors related to plan cost, plan features and company grant practices, assigns points for each factor, and combines these points to yield a total EPSC score. In order to trigger a favorable voting recommendation, this total EPSC score generally must exceed 53 out of a maximum of 100 total points.

For 2017, key updates to the EPSC are as follows:

Pre-vesting dividends. ISS has added, as a new factor under plan features, dividends payable on unvested awards. ISS has stated that dividends on unvested awards should not be paid during any time-based or performance-based vesting period, rather only after the underlying awards have been earned. Full points will be awarded under this factor only if the plan expressly prohibits the payment of dividends prior to award vesting, and this prohibition extends to all types of awards under the plan. No points will be awarded without explicit prohibition in the plan itself, regardless of whether such prohibition is consistent

with the company's general practice. ISS has indicated that the accrual of dividends prior to vesting is acceptable, provided the dividends are payable only on or after vesting.

Minimum vesting requirement. Previously, an equity plan was awarded full points under the EPSC's "minimum vesting requirement" if the plan specified a minimum vesting period of at least one year for at least one type of award. Under the updated EPSC, an equity plan must require a minimum vesting period of at least one year for *all* types of awards, and must not permit individual award agreements or other mechanisms to eliminate or reduce the minimum vesting period to less than one year. The updated EPSC continues to permit plans to exclude up to 5% of their authorized shares from the minimum vesting requirements.

CEO grant vesting period. ISS will continue to assign points to an equity plan based on the period required for full vesting of the equity awards received by a company's CEO within the prior three years. However, under its updated policy, ISS will consider performance awards separately from time-vesting awards in applying this factor. In particular, no points will be awarded if the company's CEO has not received any performance awards in the prior three years (though half points will still be awarded if the CEO has also not received any time-based options or restricted shares).

Section 162(m)-Related Plan Proposals

Companies often seek shareholder approval of incentive plans solely for purposes of deductibility of "performance-based compensation" under Section 162(m) of the Internal Revenue Code of 1986, as amended (Section 162(m)). As a result, ISS has clarified its policy: ISS will generally issue a favorable recommendation for plan proposals that seek approval for Section 162(m) purposes *only*, unless (i) the committee administering the plan does not consist entirely of independent outsiders (in which case ISS will generally provide a negative recommendation); (ii) the plan is being presented for the first time following the company's IPO or spinoff (in which case ISS will analyze on a case-by-case basis); or (iii) the proposal includes other material plan amendments (in which case ISS will analyze on a case-by-case basis).

Ratification of Non-Employee Director Compensation

In response to the anticipated increase in proposals seeking ratification of non-employee director (NED) compensation programs, ISS has introduced a new policy that calls for a case-by-case evaluation of proposals to ratify NED compensation (similar to the qualitative evaluation of equity plans for NEDs). The evaluation is based on a holistic assessment of the following qualitative factors:

- Relative magnitude of director compensation as compared to companies of a similar profile
- Presence of problematic pay practices relating to director compensation (which include performance-vesting equity, retirement benefits and perquisites)
- Director stock ownership guidelines and holding requirements (which should generally be at least four times the annual cash retainer (or higher if equity is a large component of NED compensation))
- Equity award vesting schedules
- Mix of cash and equity-based compensation
- Meaningful limits on director compensation (including any meaningful annual limit)

- Availability of retirement benefits or perquisites
- Quality and transparency of disclosure surrounding director compensation

Other Key Updates

Other updates include:

- **Plan amendments to increase the tax withholding rate on settlement.** ISS has indicated it will generally consider plan amendments to increase the tax withholding rate as administrative in nature and neutral to shareholders' interests *unless* the plan at issue contains a liberal share recycling feature. In such cases, ISS will view the amendment negatively, though its concern may be mitigated if the plan stipulates that only the number of shares withheld at the minimum statutory rate may be recycled.
- **Problematic pay practices.** ISS' problematic pay practices now also include: (1) the payment of bonuses despite failing to achieve pre-established threshold performance criteria; and (2) the inclusion of equity gains or other pay elements when calculating change-in-control cash payments.
- **Omitting a say-on-pay proposal.** If a company fails to include a say-on-pay or say-on-pay frequency vote on its ballot when one would otherwise be expected, without providing an explanation for the omission, ISS will generally recommend against the election of the company's compensation committee chair (or the full compensation committee, as appropriate) until the company includes the vote on its ballot. Companies exempt from the say-on-pay requirements, such as those that qualify as "emerging growth companies," should therefore indicate the basis for their exemption in their proxy statements.

Next Steps Going into the 2017 Proxy Season

The policy changes and updates outlined above have several important implications for companies preparing for the 2017 proxy season (and beyond). In light of the new pay-for-performance methodology, companies should consider updating their proxy statement disclosure to discuss performance under some or all of the additional metrics, or to otherwise enhance communication with investors around the company's approach to aligning executive compensation and performance.

Companies submitting equity plan proposals should consider prohibiting the payment of dividends on unvested awards, and/or requiring a one-year minimum vesting period for all types of awards under their plans in order to increase the likelihood of a favorable EPSC outcome. In addition, companies should review any equity plan proposals submitted for Section 162(m) purposes to confirm that they align with ISS' updated policy regarding such proposals.

Lastly, companies considering a proposal seeking shareholder ratification of NED compensation (or approval of an NED equity plan) should consider the qualitative factors enumerated under ISS' newly introduced NED compensation policy. Even companies that do not intend to submit a shareholder proposal regarding NED compensation in 2017 may wish to consider ISS' new NED compensation policy when structuring NED equity and other compensation plans and programs, in case they seek shareholder approval in the future.

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Bradd L. Williamson

bradd.williamson@lw.com
+1.212.906.1826
+1.917.769.7409
New York

Austin Ozawa

austin.ozawa@lw.com
+1.212.906.4515
New York

Maj Vaseghi

maj.vaseghi@lw.com
+1.650.470.4852
Silicon Valley

Lindsey Mills*

lindsey.mills@lw.com
+1.650.463.2650
Silicon Valley

*Registered to practice in New York only; all work supervised by a California-qualified lawyer.

You Might Also Be Interested In

[2016 Year-End Key Executive Compensation Reminders and Considerations](#)

[Key Metrics: Thoughts for Directors](#)

[Examining the Impact of the 2016 US Elections on Executive Compensation](#)

[New SEC Staff Guidance on CEO Pay Ratio Disclosure Rules – Determining the Median Employee](#)

Client Alert is published by Latham & Watkins as a news reporting service to clients and other friends. The information contained in this publication should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, please contact the lawyer with whom you normally consult. The invitation to contact is not a solicitation for legal work under the laws of any jurisdiction in which Latham lawyers are not authorized to practice. A complete list of Latham's *Client Alerts* can be found at www.lw.com. If you wish to update your contact details or customize the information you receive from Latham & Watkins, visit <http://events.lw.com/reaction/subscriptionpage.html> to subscribe to the firm's global client mailings program.

Endnotes

¹ ISS has indicated that this assessment may be integrated into its quantitative review in the future.