SULLIVAN & CROMWELL LLP

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ISS Releases Updated 2019 Compensation Policy FAQs

Problematic Pay Practices Expanded to Include Problematic Good Reason Definitions; Excessive Director Compensation Policy Implementation Delayed Until 2020

On December 14, 2018, Institutional Shareholder Services ("ISS") released its U.S. Compensation Policies Frequently Asked Questions ("FAQs") for 2019. The key updates are:

- **Problematic Good Reason Definition:** ISS expanded its list of problematic pay practices, each of which is likely to result in an adverse vote recommendation, to include the use of a problematic "Good Reason" definition in a new or materially amended agreement. ISS noted that "Good Reason" triggers should be limited to circumstances reasonably viewed as a constructive termination (such as employer actions that result in a material negative change to the executive's title/role, function or compensation) and be tailored to prevent a potential windfall. Therefore, ISS will consider definitions triggered by potential performance failures, including the company's bankruptcy or delisting, to be problematic.
- **Other Problematic Pay Practices:** ISS also expanded its list of problematic pay practices to include (1) insufficient disclosure of executive compensation by externally managed issuers and (2) materially amended agreements with certain problematic features, including excessive termination or change in control severance payments. Previously, the problematic pay practices list included new or extended (but not materially amended) agreements with problematic features, and excessive termination payments were not explicitly included in the list of problematic features (although excessive change in control severance payments were previously included).
- **"Excessive" Director Compensation:** ISS previously announced that, starting with the 2019 proxy season, it would issue adverse vote recommendations for directors responsible for determining non-employee director ("NED") compensation when a company exhibited a recurring pattern of excessive NED compensation without a compelling rationale. In the FAQs, ISS updated its methodology for identifying excessive NED compensation and therefore delayed implementation of this policy until meetings occurring on or after February 1, 2020. Under the revised methodology, a company's NED compensation (using individual NED pay totals) will be compared to compensation for directors within the same two-digit Global Industry Classification Standard sector and the same index grouping. Index groupings for this purpose are the S&P 500, the combined S&P 400 and S&P 600, the remainder of the Russell 3000 Index and the Russell 3000-Extended. In recognition that compensation for directors

in board leadership positions often includes a premium, ISS will compare compensation for non-executive chairs and lead independent directors against compensation for other directors in such board leadership positions within the applicable comparison group. NED compensation will generally be considered excessive if it is above the top 2% – 3% of compensation for directors in the applicable comparison group, although for comparison groups that do not show a pronounced difference in compensation between the top 2% – 3% of directors and the median director, this may be considered a mitigating factor.

- **Front-Loaded Awards:** ISS indicated that it is unlikely to support "front-loaded" awards that cover more than four years (*i.e.*, the grant year plus three future years). When considering "front-loaded" awards, ISS will expect a firm commitment not to grant additional awards over the covered period and will consider the usual pay-for-performance considerations even more carefully.

In addition to these key updates, the FAQs also note that, although for 2019 there are no changes to the quantitative screen which is the first step in ISS's pay-for-performance evaluation, ISS will continue to explore the potential for using "economic value added" measures. Therefore, ISS will display such measures in research reports on a phased-in basis over the course of the 2019 proxy season.

Finally, the FAQs included several clarifying and/or cautionary notes. In response to the elimination of the performance-based compensation exception under Section 162(m) of the Internal Revenue Code of 1986, ISS warned that it will view negatively shifts away from performance-based compensation to discretionary or fixed-pay components. In response to the SEC's expansion of the definition of a "smaller reporting company," ISS cautioned that although smaller reporting companies are subject to more limited compensation disclosure requirements, they should continue to provide sufficient disclosure to permit shareholders to make informed decisions regarding the say-on-pay vote. Finally ISS clarified that it does not endorse or preference the use of any specific metric in executive compensation programs, including total shareholder return (which ISS uses in its quantitative pay-for-performance screen).

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