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ISS Adds Financial Performance Assessment to Quantitative Pay-For Performance Screen

Updated 2018 Guidelines Include Additional Changes to Pay-for-Performance Test and Equity Plan Scorecard Calculations

On December 14th, ISS released its Frequently Asked Questions (FAQ) documents on U.S. Compensation Policies and U.S. Equity Compensation Plans as well as a whitepaper on Pay-for-Performance Mechanics designed to help stakeholders understand upcoming changes to its compensation-related methodologies. These documents are ISS's final, and more fulsome, description of the methodological changes previewed in its preliminary FAQs document which was released in November. All changes will be effective for annual meetings on or after February 1, 2018.

ISS announced two key changes to its methodology for 2018. First, ISS modified its quantitative pay-for-performance screen, most notably by adding a new "Financial Performance Assessment" (FPA) which will incorporate the review of three or four relative financial metrics in addition to the long-standing relative total shareholder return (TSR) metric. Second, ISS updated its Equity Plan Scorecard (EPSC) to require a higher passing score for S&P 500 companies and simplified certain other factors. While the overall impact of these changes will become more clear in the coming months, issuers should strive to gain a thorough understanding of how ISS will evaluate their compensation program in order to draft effective disclosure and have productive compensation-related engagements with investors.

Financial Performance Assessment Incorporated into the Quantitative Pay-For-Performance Screen

In 2017, ISS previewed incorporation of the FPA into the quantitative pay-for-performance by adding a version of the FPA to its qualitative evaluation. ISS signaled that this addition would be assessed and likely incorporated into the quantitative screen in coming years. The FPA will be applied as a secondary measure after ISS's original three quantitative screens - multiple of median, relative degree of alignment, and pay-TSR alignment. This new screen will compare the percentile ranks of a company's CEO pay and financial and operational performance across three or four financial metrics, relative to its ISS peer group, over the prior three-year period.

Under the new methodology, the original three screens will continue to be used as the initial quantitative screen to identify cases of significant misalignment of CEO pay and performance. The FPA will then be applied as the final input in determining an overall concern level. The FPA test may impact companies that either scored a medium concern under the initial quantitative screen or a low concern, but with results on any of the three original screens that border on a medium concern threshold. As currently constructed, the FPA is intended to be applied at the margins and most issuers should not be affected, though companies should continue to monitor outcomes as ISS applies the test in 2018.

For companies with a medium concern result in the initial quantitative screen, a showing of relatively strong fundamental financial performance in the FPA may reduce the overall quantitative concern level to low. For companies with a low concern result in the initial quantitative screen, a showing of relatively poor fundamental financial performance in the FPA may increase the overall quantitative concern level to medium. Companies that receive initial low concern levels where all three original screens scored below a certain threshold or high concern levels will not be eligible for modification by the FPA result.

How the Financial Performance Assessment is Calculated

- The FPA utilizes three or four financial metrics, selected and weighted depending on a company's industry, including ROIC, ROA, ROE, EBITDA growth, as well as cash flow from operations growth.
- The individual metric performance ranks vs. peers are combined into a weighted average performance rank.
- This weighted average performance rank is compared to the company's CEO pay rank, with a result ranging from -100 (high relative pay and low relative performance) to +100 (low relative pay and high relative performance).
- Performance is measured using the 12 most recent trailing quarters (16 for growth metrics) as of ISS's quarterly data download from Compustat, and the assessment uses reported, rather than adjusted, performance results.

Multiple of Median Threshold Changed

In 2018, ISS will change the threshold for a medium level of concern on the Multiple of Median screen, which expresses the prior year's CEO pay as a multiple of the median CEO pay of its peer group, from 2.33 to 2.00. This change will apply to S&P 500 constituents covered by the ISS policy. The high level of concern threshold will remain at 3.33 which will likely have the effect of more companies receiving a medium score on that specific test, but the same number of companies receiving a high score. A company receives an overall high level of concern if it receives one high or two medium scores across the three tests, and an initial medium level of concern if it receives at least one medium score.

New Methodology Introduced for Calculating TSR

In order to reduce the impact of stock price volatility around the beginning and end of the three-year TSR period, in 2018, ISS will calculate TSR by averaging the closing prices for each trading day of the months at the beginning and end of the performance period, with dividends reinvested at the end of the month. If a company's fiscal year end is on or after the 15^{th} of the month, then that monthly average will be used. If a company's fiscal year end falls prior to the 15^{th}, the monthly average for the prior month will be used.

Equity Plan Scorecard (EPSC) Changes include Requiring a Higher Passing Score and Simplifying Certain Factors

- **Higher Passing Score for EPSC:** In 2018, for companies in the S&P 500, the passing score for the EPSC model will increase from 53 points to 55 points. The passing score will remain 53 for all other EPSC models (the Russell 3000, Non-Russell 3000, Special Cases - Russell 3000 / S&P 500 models, Special Cases – Non-Russell 3000).
- **Change in Control Vesting:** Companies can earn only full or no credit for this factor. For performance-based awards, full credit will be earned in instances where the awards accelerate only when actual performance is achieved, or vest pro-rata of target based on the elapsed proportion of the performance period, or a combination of both actual & pro-rata (or awards are forfeited). For time-based awards, in order for full credit to be earned, acceleration upon a change in control cannot be automatic single trigger or discretionary.
- **Holding Requirement:** Companies can earn only full or no credit. A company will get full credit for a 12-month holding period or through retirement (down from a 36-month period). A company will receive no credit for a holding period of less than 12 months. Companies with holding periods that apply only until ownership guidelines are met will not receive credit on this factor.
- **CEO Vesting Requirements:** Companies can earn only full or no credit. In order to receive full credit, a company must have a vesting requirement of at least three years from the date of grant until all shares from the award vest. The vesting requirement must apply to time-based options, time-based restricted stock, and performance-based equity awards.

- **Broad Discretion to Accelerate:** Companies will receive full credit on this factor only where discretion to accelerate awards is limited to cases of death or disability. Authority to accelerate awards in the case of a change in control will no longer receive credit under this factor.

Takeaways for Issuers

Starting in 2018, superior relative TSR performance alone will not guarantee a low-concern rating from ISS. Relative fundamental financial performance will now play a role in ratings, with the highest impact felt at companies that come in at the margin of the traditional ISS quantitative analysis. Because the FPA test can move a company from low to medium concern (which triggers an automatic in-depth qualitative review of the pay programs) companies should consider conducting a preliminary assessment of how they compare to their ISS peers and refine their CD&A disclosures to emphasize which financial metrics are most important to their business and how they are performing against these measures.

In regard to EPSC modifications, in some cases, these changes will make it easier for a company to earn full credit on a given factor. In other instances, eliminating partial credit on some factors will remove the opportunity to collect points toward a passing score. While the simplification of factor scoring may allow companies to better understand where they will receive points or not, it is too early to determine the overall impact of these changes.

Issuers should consider affirmatively disclosing why some of ISS's metrics might not be as important or reflective of industry or company performance, as well as why any adjustments to the relevant metrics are appropriate for the company. When viewed in combination with ISS's recently-announced 2018 benchmark policy changes, which feature modifications to the evaluation of non-employee director compensation and increased consideration of disclosure related to responsiveness to say-on-pay, these updated policies highlight the importance of effective disclosure and proactive compensation-related engagement with investors.

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