Davis Polk

ISS Releases Preliminary Updates to 2020 Compensation-Related Policies

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As we previously **discussed**, ISS recently released its **U.S. Preliminary Compensation Policies FAQ**, which provides interested parties an advance view of ISS' answers to select questions posed to ISS regarding potential changes to its U.S. compensation policies. Updated compensation-related FAQ documents and a methodological whitepaper—which will include a detailed introduction of ISS' new Economic Value Added (EVA) metrics—will be available in mid-December. These changes are effective for meetings held on or after February 1, 2020. The below summarizes the key changes outlined by the preliminary FAQ.

Changes to the Quantitative Pay-for-Performance Screens for 2020

ISS applies an initial set of quantitative screens followed by a set of qualitative screens when evaluating say-on-pay proposals. The quantitative screens are designed to identify outlier companies with a significant pay-for-performance misalignment, which will then be assessed through in-depth qualitative screens. The changes summarized below are modifications to the quantitative screens that will be effective for annual meetings on or after February 1, 2020. For a more detailed summary of ISS' process for assessing say-on-pay proposals, see our ***November 2018 say-on-pay update***
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- Primary Screens Thresholds. The thresholds that trigger concern on two of ISS' three primary screens—Relative Degree of Alignment (RDA) and Pay-TSR Alignment (PTA)—will change. The Multiple of Median (MoM) thresholds will remain the same for 2020.
- Use of EVA Metrics in Secondary Screen. ISS began showing EVA metrics, which effectively are metrics that aim to assess a company's ability to generate and increase value on a three-year basis, in its 2019 proxy research reports for informational purposes only. ISS' secondary quantitative screen, the Financial Performance Assessment (FPA), will now be based on EVA metrics instead of the GAAP metrics used in 2019. Otherwise, the basic operation of the FPA will be the same. EVA metrics to be used are: EVA Margin, EVA Spread, EVA Momentum vs. Sales and EVA Momentum vs. Capital.
  - For more information on EVA metrics, which are based on audited financial data reported in annual and quarterly public filings, ISS offers an **EVA resource center** with a number of reports and webinars on EVA metrics.
  - GAAP metrics will continue to be displayed for informational purposes, and they may inform ISS' evaluation of long-term pay and performance alignment.
- Secondary Screen Exceptions. Most companies that are subject to the primary pay-for-performance screens will also be subject to the secondary FPA screen; however, there are exceptional cases where the FPA screen will not be applied, including those listed below:
  - REITs. The FPA screen will not be applied for companies under GICS industry 601010 Real Estate Investment Trusts (REITs), because ISS is currently refining its methodology for classifying REITs and for calculating their EVA.
  - Revenue or Capital below $5 Million. The EVA metrics exclude financial periods in which a company's revenue or capital was below $5 million. The FPA may be inapplicable if this exclusion results in insufficient data for the EVA

metric calculations.

- Less than Two Years of Data. A minimum two-year period is required for CEO pay and the EVA metrics used in the FPA screen. The FPA test may be excluded if insufficient data exists for either.

– Other Changes. No other changes will be made to the quantitative screens for 2020; however, ISS reports will feature, for informational purposes only, a three-year MoM view of CEO pay as a measure of long-term pay on a relative basis.

Changes to the U.S. Equity Plan Scorecard for 2020

ISS evaluates equity plan proposals under its Equity Plan Scorecard (EPSC) policy, which weighs three pillars—plan cost, plan features and grant practices. ISS will generally vote against the plan proposal if the combination of these three pillars indicates that the plan is not in shareholders' interests or if any "overriding factors" apply. The below is not an exhaustive list of updates to the EPSC methodology for 2020. An updated, comprehensive FAQ document will be published in mid-December.

– Passing Scores. The passing scores for all U.S. EPSC models will remain the same for 2020. However, there will be, as in prior years, weighting and point reallocations among some of the individual factors within each EPSC model.

– New Overriding Factor—Evergreens. Starting in 2020, "evergreen" provisions (i.e., provisions providing for automatic share funding additions, typically on an annual basis, over the life of the equity plan) will be considered an overriding factor. Previously, "evergreen" provisions were a negative factor in the EPSC methodology, but such provisions were not on ISS' list of plan features that may result in an against recommendation regardless of other EPSC factors.

  - ISS expanded on its rationale for this change in its **2020 Americas Policy Updates**. Prior to the Tax Cuts and Jobs Act of 2017 (TCJA), many companies sought shareholder approval of equity incentive plans at least every five years to comply with the requirements of the performance-based pay exception of Internal Revenue Code Section 162(m). The TCJA repealed the performance-based pay exception and, since then, ISS has seen a significant drop in the number of equity plans brought to a shareholder vote (a 27% year-over-year drop from 2017 to 2018 and sustained low levels of equity-plan proposals in 2018 and 2019).

The preliminary FAQ states that there are no other substantive changes to the other EPSC factors.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

Kyoko Takahashi Lin
+1 212 450 4706
kyoko.lin@davispolk.com