ISS, Tax Reform and Pay Ratio: The Compensation Committee's 2018 Checklist

Compensation Series

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Pearl Meyer

NACD
NATIONAL ASSOCIATION OF CORPORATE DIRECTORS

Meet The Presenters

Mary Beth Vitale (moderator) is a director of CoBiz Financial Inc. and GEHA Inc. Vitale chairs CoBiz's nominating and governance committee and also oversees the organization's IT and cyber-security processes and policies. She also chairs GEHA's risk and technology committee and serves on the executive committee. Previously, Vitale was lead director for Eye-Ris Inc. and on the board of Zynex Inc. She chaired Zynex's compensation committee and served on its audit committee. Vitale is a former chair and CEO of Westwind Media Inc. and a past director of both Intrado Inc. and RMI. She is a faculty member for NACD's Board Advisory Services. She is a past president and corporate officer of AT&T Inc. Vitale is a founding commissioner of the Colorado Governor's Commission on Science and Technology, a past president and COO of Rocky Mountain Internet, a past chair of NACD's Colorado Chapter, and a founding co-chair of the Greater Colorado Chapter of Women Corporate Directors.

Deb Lifshey is a managing director in Pearl Meyer's New York office, where she specializes in advising clients on compensation matters from a legal perspective including securities disclosure, taxation and corporate governance issues, negotiation contracts, and reasonableness opinion letters. She is a member of the New York and Florida Bars.

Sharon Podstupka is a principal with Pearl Meyer and focuses on executive and broad-based pay communication consulting, including internal communications that educate and engage people in their pay programs. She also helps develop critical shareholder communications that clearly explain pay-for-performance. Her key areas of expertise are communication strategy, stakeholder management, and content development.

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https://www.pearlmeyer.com/knowledge-share/webcast/tax-reform-pay-ratio-and-iss-the-compensation-committees-2018-checklist

and within the webinar console

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Agenda

Tax Reform

- Current status and potential impacts on compensation

CEO Pay Ratio

- 2018 is here!

ISS and Glass Lewis proxy voting guidelines

- 2018 updates released

Tax Bills and Compensation

Key provisions in both House and Senate bills include:

- Reduction in maximum corporate tax rate from 35% to 20%
- Changes to IRC Section 162(m) to:
  - ***Remove exceptions for performance-based pay*** and commissions
  - Include the Principal Financial Officer as a covered employee and "once an NEO, always an NEO"
  - Extend to payments made beyond termination of employment or death
- Elimination of individual Alternative Minimum Tax (AMT) (expires in 2026 in the Senate bill)
- Lower individual tax rates (expires in 2026 in Senate bill)
- Elimination of numerous itemized deductions and exemptions, including state and local income taxes
- Limitation on carried interests; capital gains treatment is only applicable if held for minimum of three years

Note: the proposals to tax-deferred compensation upon vesting (i.e., repeal 409A and replace with 409B) have been removed from both bills.

Tax Bills and Compensation (cont'd)

Potential implications and impact on executive compensation

- Elimination of performance-based exception under Section 162(m)
  - Lost tax deductions under current rules would likely be somewhat offset by lower corporate tax rates
  - Potential for more discretionary adjustments to payouts—including upside—to reflect non-formulaic performance factors
  - However, shareholders still strongly prefer "performance-based" incentives based on pre-set goals
- Elimination of AMT may make Incentive Stock Options (ISOs) more attractive to executives and less costly for corporations
  - ISOs have tax benefits vs. "non-qualified stock options" (NQSOs); if held for a year after exercise and two years after grant, they are exempt from ordinary income tax and instead taxed as long-term capital gains
  - However, under current rules, income spread at exercise can trigger AMT and complicate tax planning for the executive
  - Many companies avoid ISOs since the spread on ISO exercises is not deductible to the company (while the spread on NSOs is deductible); lower corporate tax rates would reduce the lost deduction
- Lower current individual tax rates may discourage the use of deferred compensation to delay taxation

Polling Question #1

Has your board talked about tax reform and any potential implications for executive compensation?

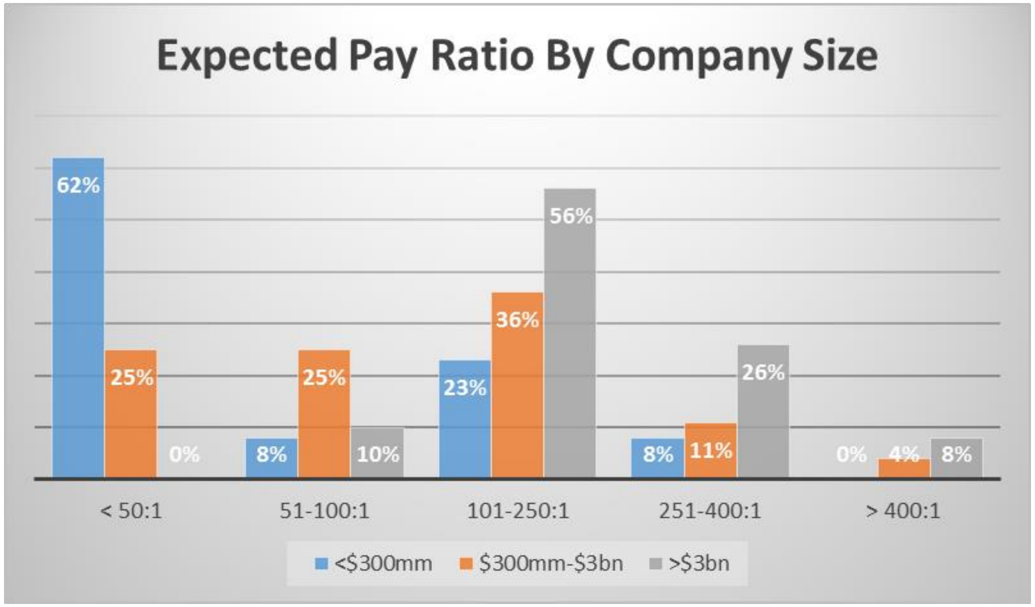
- *Yes*
- *We have discussed tax reform generally, but not specifically covered executive compensation*
- *No*

CEO Pay Ratio: What Have We Learned So Far?

Pay ratios will vary based on a number of factors:

- Company size, industry, stage in lifecycle
- Organizational design; use of temporary, seasonal, part-time, and/or contract workers
- Global workforce and locations

Our recent Pearl Meyer survey of nearly 300 companies shows expected ratios by company size



Source: Pearl Meyer On Point: Looking Ahead to Executive Pay Practices in 2018

CEO Pay Ratio: What Have We Learned So Far?

- **Proxy advisory firms will include the data in their reports, but will not factor it in their voting decisions in this first year.**
- **Institutional investors indicated they will pay attention to it in this first year, but will likely not use it in a material way.**
- **Disclosures will be compliant, but as brief as possible.**
  - Placement of the disclosure will likely be after the CD&A narrative.
- **Focus is turning away from the disclosure and toward other communication planning:**
  - What are we most concerned about and why? What is our potential messaging risk?
    - Is it the ratio itself?
    - Is it the amount our CEO is earning?
    - Is it the level of median employee pay (i.e., perceived to be to high or too low?)
  - When, if at all, is the right time to communicate to our workforce about the CEO pay ratio?
    - Should we explain what the CEO pay ratio rule is and how it may impact our workforce?
    - How soon before the filing should we communicate, if at all?
    - What questions should key people be prepared to answer should they arise?

CEO Pay Ratio: Communication Planning

Illustrative activity milestones based on a calendar-year filing:

December
- Finish calculations
- Draft proxy narrative
- Assess communication risk

January
- Identify internal stakeholders
- Develop preliminary messages
- Determine delivery methods

February
- Draft collateral materials
- Test with key leaders (Compensation Committee?)
- Preview with select stakeholders

March
- Educate select stakeholders shortly before proxy filing
- Monitor industry competitors filings (and the news!)
- Refine collateral materials, if needed

April
- Reinforce compensation messages to your workforce

Polling Question #2

Has the CEO Pay Ratio issue led to a discussion of gender pay equity on your board?

- *Yes*
- *No*

2018 ISS Compensation Policy Updates

In November, ISS updated its annual proxy voting guidelines; further details will be issued in December

Policy	Update
Pay-for-Performance Methodology	Financial pay-for-performance evaluation (introduced in 2017) will be secondary screen on top of ISS' *quantitative* test for Russell 3000 companies. Three-year performance on several metrics will be measured relative to the ISS peer group; metrics will vary by GICS code (typically 4-6 metrics); weights have not been specified.
Compensation Committee Communication and Responsiveness	If previous say-on-pay (SOP) proposal received < 70% support, ISS considers the adequacy of the company's response (on a case-by-case basis). For 2018, ISS clarified/added three points that it will consider: • Timing and frequency of institutional investor engagement and whether independent director(s) participated; • Disclosure of specific concerns raised by shareholders that led them to oppose SOP; and • Detailed disclosure of meaningful actions taken by the company to address shareholders' concerns.
Problematic Pay Practices	In the absence of an SOP vote on the ballot, problematic pay practices that may trigger votes against the committee or full board now include: • Failure to provide an SOP vote if required by regulation or the company's declared SOP voting frequency; and • Failure to provide a say-on-frequency (SOF) vote when required by regulation. ISS removed failure to meet a burn rate commitment (last commitment expired in 2017).

2018 ISS Compensation Policy Updates (cont'd)

Policy	Update
Pledging of Company Shares	ISS will recommend votes "against" members of the committee (responsible for oversight) if a significant level of pledged company stock by executives or directors raises concerns. ISS will consider on a case-by-case basis: (i) a proxy-disclosed, anti-pledging policy that prohibits future pledging activity; (ii) magnitude of the aggregate pledged shares; (iii) disclosure of progress in reducing the magnitude of aggregate pledged shares over time; (iv) proxy disclosure that shares subject to stock ownership and holding requirements do not include pledged company stock; and (iv) any other relevant factors. *This codifies what ISS has been doing in practice since 2013.*
Non-Employee Director ("NED") Pay	ISS will consider votes against board and committee members responsible for approving/setting NED compensation when there is a recurring pattern (2+ years) of excessive NED pay magnitude without compelling rationale or mitigating factors. This will impact voting in 2019 (i.e., based on 2018-2019 pay). ISS has "identified some extreme outliers" relative to peers, but has not provided guidance on definition of "extreme outliers."
Gender Pay Gap Shareholder Proposals	On proposals requesting reporting of a company's pay data by gender or policies and goals to reduce existing gender pay gaps, ISS is switching from case-by-case approach to require consideration of: • Company's current policies and disclosures regarding diversity and compensation practices; • Company's compensation philosophy and use of fair and equitable compensation practices; • Whether the company subject to recent controversies/litigation; and • Whether the company's disclosures/reporting lags its peers.

2018 ISS Preliminary FAQs

ISS also issued Preliminary FAQs in November; final FAQs will be published in December 2017

FAQ item	Changes/updates
Quantitative Pay-for-Performance Test	TSR calculation will be based on the average of the beginning and ending stock price for the month closest to a company's fiscal year-end (considers dividends/splits during that month). Threshold for medium level of concern on the Multiple of Median ("MOM") test reduced to 2.0 from 2.33 for ***S&P 500 companies***. Financial performance assessment will be a "secondary screen" after the traditional quantitative pay-for-performance tests have been applied. Metrics will vary by GICS code, but weights have not been specified.

Equity Plan Scorecard ("EPSC")	Passing score increased from 53 to 55 (***S&P 500 only***)
	
	Following Plan Features and Grant Practices factors will be simplified to provide "all or nothing" points (no more partial points); full points awarded only if plan provides:
	
	• Change-in-control (CIC) vesting
	    • For time-based awards, no automatic acceleration (and no discretionary vesting) upon CIC
	    • For performance-based awards, only vesting based on pro-rata or actual (or combination of both)
	• Board discretion to accelerate vesting; discretion limited to acceleration for death or disability only
	• CEO vesting requirement: for any type of grant, at least three years from date of grant until date when all shares from the award vest
	• Holding requirement: at least 12 months (down from 36 months) or until end of employment

2018 ISS Policies: Open Items

Two compensation-related questions from their Policy Survey were not included in ISS' Policy Updates, but could still be addressed in mid-December:

- Consideration of the CEO Pay Ratio
  - Investor and non-investor views were strongly divergent on usefulness
  - ISS has unofficially suggested it does not intend to use the pay ratio in its assessment of say-on-pay proposals, at least for the first year
- Consideration of outcomes-based measures (realizable pay) as part of ISS' Quantitative Pay-for-Performance Test
  - Investors and non-investors were generally in favor of using, generally to mitigate concerns regarding pay-TSR alignment

2018 Glass Lewis Proxy Guidelines

Also in November, Glass Lewis released its 2018 Proxy Paper Guidelines; not many significant changes

Policy	Update
CEO Pay Ratio	Glass Lewis will display the pay ratio as a data point in proxy paper. It will not be a determinative factor in voting recommendations (although Glass Lewis notes that is does have potential to provide additional insight when assessing a company's pay practices).
Pay-for-Performance	There is no change to model, but an explanation of grading system. A "C" does not indicate a significant lapse in compensation committee effectiveness; rather, a "C" identifies companies where the pay and performance percentile rankings relative to peers are generally aligned.
Board Gender Diversity	Glass Lewis will continue to closely review the composition of the board and may note as a concern instances where board lacks representation of diverse director candidates. No voting recommendations made in 2018 solely on the basis of diversity, but it will be a consideration in evaluating companies' oversight structures. Beginning in 2019, they will generally recommend voting against the nominating committee chair of a board that has no female members (and possibly other committee members depending on size, industry, and governance profile of the company).
Director Commitments	There is no change to overboarding policy, but clarification that when determining whether to apply limit of two total board memberships for public executives, they will evaluate the specific duties and responsibilities of the executive role, in addition to the company's disclosure regarding that director's time commitments.

2018 Glass Lewis Proxy Guidelines (cont'd)

Policy	Update
Dual-Class Share Structure	This is not favored by Glass Lewis. It will now be an additional factor in determining whether shareholder rights are being severely restricted.
Board Responsiveness	Glass Lewis clarified that it expects boards to respond to shareholder dissent from a proposal at an annual meeting of more than 20% of votes cast. Where there is a dual-class share structure with disproportionate voting and economic rights, they will carefully examine the level of approval or disapproval attributed to unaffiliated shareholders when determining whether board responsiveness is warranted. Where vote results indicate that a majority of unaffiliated shareholders supported a shareholder proposal or opposed a management proposal, Glass Lewis believes the board should demonstrate an appropriate level of responsiveness.
Virtual Shareholder Meetings	There is no impact on 2018 voting. Beginning in 2019, they will recommend voting against members of the governance committee of a board where the board is planning to hold a virtual-only shareholder meeting and the company does not provide such disclosure.

Questions?

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