

ISS Updates “Pay for Performance” Methodology

On November 8, 2016 Institutional Shareholder Services (“ISS”) announced several significant revisions to its methodology for evaluating the link between pay and performance for U.S. companies. As is well-understood, this evaluation is used by ISS to formulate the voting recommendation on companies’ shareholder advisory proposals on the compensation of their named executive officers (the so-called “Say-on-Pay” proposal) for its institutional shareholder clients. These revisions will be reflected in the corporate governance and executive compensation policies that ISS will use in the upcoming 2017 proxy season.

The Press Release from ISS announcing the revisions is available at the [following link](#) »

Background

Since 2012, ISS has applied a methodology encompassing both quantitative and qualitative factors in evaluating a company’s executive compensation program. Pursuant to this methodology, ISS conducts a two-step analysis to identify strong or satisfactory alignment between a company’s executive compensation program and its financial performance over a sustained period. Since the enactment of the Say-on-Pay requirement, the results of this analysis have been primarily used by ISS to formulate its voting recommendation on individual Say-on-Pay proposals (the analysis may also be relevant in formulating voting recommendations on proposals to re-elect directors or approve new or amended equity compensation plans).

ISS’ analysis starts with a “quantitative” assessment of:

- the relative degree of alignment between a company’s total shareholder return (“TSR”) ranking and its CEO’s total compensation ranking within an ISS-constructed group of peer companies, as measured over a three-year period (the “Relative Degree of Alignment” test);
- the multiple of the CEO’s total compensation relative to the peer group median (the “Multiple of Median” test); and

- the absolute alignment between the trend in the CEO’s pay and the company’s TSR over the prior five fiscal years (the “Pay-TSR Alignment” test).

The analysis then shifts to an assessment of a series of “qualitative” factors, if they are deemed relevant to determining how various pay components may work to encourage or undermine long-term value creation and alignment with shareholder interests. Among other things, these factors include the overall ratio of performance-based compensation, the adequacy of the company’s disclosure and rigor of its performance goals, and the company’s peer group benchmarking practices.

If the quantitative “screen” demonstrates a significant unsatisfactory long-term “pay-for-performance” alignment, the qualitative review tends to be more intensive than in situations where ISS finds a satisfactory alignment.

Revisions to Methodology

Beginning with annual meetings of shareholders held on or after February 1, 2017, this methodology will be revised to reflect the following changes:

- ISS will evaluate a company’s performance relative to its ISS-constructed peer group on up to six financial metrics, and present the results in a standardized table in the company’s proxy research report:
 - ▶ Return on invested capital;
 - ▶ Return on assets;
 - ▶ Return on equity;
 - ▶ Revenue growth;
 - ▶ Growth in earnings before interest, taxes, depreciation, and amortization (“EBITDA”); and
 - ▶ Growth in cash flow from operations.

These metrics will be evaluated on a three-year basis, along with TSR, with the use of each metric and corresponding weighting varying based on a company’s four-digit GISC’s industry group.

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- ISS will use the relative financial metric results in its qualitative “pay-for-performance” analysis during the 2017 proxy season.
- The existing Relative Degree of Alignment test will only apply to companies with at least two full fiscal years of both trading data (“TSR”) and compensation data (“CEO pay”). ISS had previously conducted this test for companies with only one full fiscal year of TSR and CEO pay data.

ISS will compare a company’s performance on each of the enumerated metrics against its ISS-constructed peer group looking also at relative compensation levels, and present the results, including an overall weighted financial performance metric, in a new standardized table contained in its proxy research reports. This weighted financial performance metric will measure relative financial performance against relative granted (presumably reported) pay, and will generate a numeric result indicating the alignment between three-year financial metric performance and three-year granted pay.

Initial Observations. ISS announcement is not a surprise as it has been signaling for some time a possible shift in the composition of its “pay-for-performance” methodology. The sole use of TSR to assess a company’s financial performance has been subject to criticism since the methodology was first adopted in 2012. For example, even where a company has been performing well based on its underlying financials, the failure of the market to reflect that in its stock price would often lead to a perceived pay-for-performance “disconnect.” The changes are intended to offer ISS clients a more contextual understanding of a company’s financial performance when evaluating pay levels.

It appears that, given the significance of the changes, ISS is taking a cautious approach to the incorporation of the revisions in its methodology. ISS has indicated that the new financial assessment *will not* be a component of its quantitative “pay-for-performance” analysis for 2017. Consequently, the calculation and scoring of the three existing tests in the quantitative analysis – Relative Degree of Alignment, Multiple of Median, and Pay-TSR Alignment, will not be impacted by the changes.

As noted above, however, ISS may use the relative financial performance information in its qualitative analysis of a company’s “pay-for-performance” alignment. For the 2017

proxy season, no changes have been disclosed to the quantitative pay-for-performance tests, although ISS is leaving the door open for changes in 2018 and beyond.

ISS is expected to publish a more detailed set of “Frequently-Asked Questions” in December 2016 that may provide more insight into these changes, including the methodologies to be used for companies by industry.

Need Assistance?

Compensia has significant experience in helping companies understand and address ISS’ corporate governance and executive compensation policies. If you have any questions on the topics covered in this Thoughtful Pay Alert or would like assistance in assessing how the policies are likely to affect your executive compensation program, please feel free to contact us. ■

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