

ISS Updates Pay-for-Performance Evaluation Methodology for 2017

November 10, 2016

On November 8, 2016, the proxy advisory firm Institutional Shareholder Services Inc. (ISS) released **updates** to its methodology for making its pay-for-performance evaluations of U.S. public companies for 2017. Pay-for-performance is one of three compensation areas that ISS evaluates when it recommends for or against companies' "say on pay" votes. It can also impact ISS' recommendations regarding director elections (particularly those directors who are on the compensation committee) and shareholder approval of equity compensation plans.

The policy updates for U.S. public companies, effective February 1, 2017 are:

- ISS will determine relative financial performance for six new metrics, as compared to that of the company's ISS peer group, with differing weighting for the metrics depending on the industry. Previously, ISS focused on total shareholder return (TSR), which will remain a metric; and
 - This additional information will *not* impact any quantitative screening results during the 2017 proxy season, but
 - *May* be referenced in the qualitative review, and its consideration may mitigate or heighten identified pay-for-performance concerns.
- For newly public companies, ISS will consider relative degree of alignment (RDA) in determining the overall quantitative concern only where the company has a minimum of two years of pay and TSR data. RDA measures the degree of alignment between the company's annualized TSR rank and the CEO's annualized total pay rank within a peer group.

In addition, ISS has announced that peer submission windows will open, starting on November 28, 2016 and closing on December 9, 2016, for companies holding shareholder meetings between February 1, 2017 and September 15, 2017, in order for ISS to update the company's peer group.

Updated Pay-for-Performance Evaluation Methodology

What are the new financial metrics that are being added, and how will they be weighted?

ISS will display a company's three-year performance based not only on TSR but also on a weighted average of six financial metrics, relative to its ISS-selected peer group:

- Return on equity;
- Return on assets;
- Return on invested capital;
- Revenue growth;
- EBITDA growth; and
- Cash flow (from operations) growth.

The metrics and weightings will be based on the company's four-digit GICS industry group, and it is possible that some weightings will be as low as zero. ISS has stated that it has conducted extensive back-testing over multiple years.

The weighted financial performance metric will measure relative financial performance against relative granted pay, and will generate a numeric result indicating the alignment between three-year financial metric performance and three-year granted pay.

ISS may release further FAQs on its use of financial metrics, which may provide additional background.

How do ISS' financial metrics compare to those used by Glass Lewis?

Historically, Glass Lewis has looked at more than TSR in determining pay-for performance alignment. Glass Lewis' other metrics are:

- Earnings per share growth;
- Change in operating cash flow;
- Return on equity;
- Return on assets;
- Tangible book value per share growth for companies in the Banks, Diversified Financials and Insurance sectors; and
- Growth in funds from operations for most real estate investment trusts.

What are ISS' changes to the RDA assessment?

RDA measures the degree of alignment between the company's annualized TSR rank and the CEO's annualized total pay rank within a peer group. Typically, the RDA measure uses annualized three-year TSR – i.e., the annualized rate of the three 12 month periods in the three-year measurement period (calculated as the geometric mean of the three TSRs). However, for newly public companies, ISS has used shorter time periods.

Starting in 2017, RDA assessment will only be considered in the overall quantitative concern level when the company has a minimum of two years of pay and TSR data. Companies that only have one year of data will receive an N/A (not applicable) for their RDA assessment.

How has ISS evaluated pay-for-performance in the past?

Previously, ISS conducted a pay-for-performance analysis to identify alignment between pay and performance over a specified period of time using *quantitative* screens that evaluated:

- Peer group alignment, which was based on (1) RDA, or the degree of alignment between the company's annualized TSR rank and the CEO's annualized total pay rank within a peer group, each measured over a three-year period, and (2) multiple of median, or the multiple of the CEO's total pay relative to the peer group median; and
- Absolute alignment, which was the absolute alignment between the trend in CEO pay and company TSR over the prior five fiscal years.

As a next step, ISS also examines the following *qualitative* factors, as relevant to evaluating how various pay elements may work to encourage or to undermine long-term value creation and alignment with shareholder interests:

- Ratio of performance- to time-based equity awards;
- Overall ratio of performance-based compensation;

- Completeness of disclosure and rigor of performance goals;
- Company's peer group benchmarking practices;
- Actual results of financial / operational metrics, such as growth in revenue, profit, cash flow, etc., both absolute and relative to peers;
- Special circumstances related to, for example, a new CEO in the prior fiscal year or anomalous equity grant practices;
- Realizable pay compared to grant pay; and
- Any other factors deemed relevant.

What motivated ISS to revise its methodology?

In response to ISS' 2017 global benchmark policy survey, investors were highly supportive of using metrics beyond TSR for pay-for-performance evaluations, with 79 percent answering that they support or strongly support the use of additional metrics. Nineteen percent of investors were neutral about the idea, and only 3 percent were opposed or strongly opposed. Similarly, issuers strongly supported the use of additional metrics, with 68 percent responding that they support or strongly support the inclusion of additional financial metrics, while only 11 percent of issuer respondents opposed or strongly opposed their inclusion.

When will the updated methodology go into effect?

The updated methodology for the comparison of the subject company's CEO pay and financial performance ranking relative to its ISS-defined peer group will be added to ISS' benchmark policy proxy research reports beginning February 1, 2017.

What impact will this have on the 2017 proxy season?

The additional financial metrics will not impact the quantitative screening results during the 2017 proxy season, but it may be referenced in the qualitative review and its consideration may mitigate or heighten identified pay-for-performance concerns.

The RDA change will apply during the 2017 proxy season.

What impact will this have on the 2018 proxy season?

ISS has not said specifically, but the additional financial metrics could be part of the quantitative screen starting in 2018.

Peer Group Submission

When does the peer group submission window open and close?

ISS' peer submission window for U.S. companies will run from November 28, 2016 to December 9, 2016, for companies holding shareholder meetings between February 1, 2017 and September 15, 2017, including those subject to the updated pay-for-performance evaluation methodology.

Implications

What should affected companies be doing now?

ISS' change in their financial metrics underscores the importance of explaining the company's philosophy regarding aligning pay with performance and the manner in which that is achieved. Companies that have not historically discussed their financial performance without metrics other than TSR may want to discuss

their financial performance using some or all of the additional metrics that will be considered by ISS, to the extent that such metrics are relevant to them.

Companies may also want to submit updates regarding their peer group to ISS.

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