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Meridian Client Update

ISS Modifies CEO Pay-for-Performance Assessment

Institutional Shareholder Services (ISS) recently announced a material change in its U.S. pay for performance assessment that will take effect for the 2017 proxy season. The modified U.S. pay for performance assessment will include a new qualitative component in its analysis in which ISS compares relative financial performance using a weighted average of multiple financial metrics.

Currently, ISS's pay-for-performance evaluation for Russell 3000 companies includes a quantitative analysis comparison of CEO total pay and company performance, as measured by total shareholder returns (TSR) over various time horizons on both a relative and absolute basis (Quantitative Analysis). If the Quantitative Analysis shows that significant pay misalignment exists, then ISS will perform a more in-depth qualitative assessment, taking into consideration a number of unweighted factors to determine whether a company's pay practices mitigate or facilitate the misalignment (Qualitative Analysis). When the qualitative assessment shows that the pay misalignment is "facilitated by company pay practices", ISS will likely recommend an AGAINST vote on a company's Say on Pay proposal.

For 2017, ISS will expand the Qualitative Analysis to include an evaluation of a company's performance relative to ISS-determined peers based on a weighted average of up to six financial metrics. Such evaluation will include several of the following financial metrics measured on a **three-year basis**.

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

ISS will select applicable metrics and assign a weight to each metric based on a company's industry. ISS has not disclosed its methodology for determining the weighted average of the financial metrics.

ISS also announced that it will limit the application of its Relative Degree of Alignment (RDA) component of its Quantitative Analysis, which measures the degree of alignment between a company's TSR and CEO total pay over three years compared to ISS-determined peers. The RDA test will only be included in the overall Quantitative Analysis when the subject company has a minimum of two years of pay and TSR data. ISS will not include the RDA test component in its Quantitative Analysis for companies that only have one year of data.

The changes to its U.S. pay for performance assessment will take effect on February 1, 2017.

In addition, ISS announced that U.S. and Canadian companies may submit changes to their self-selected peer groups to ISS from November 28 to December 9. As a general rule, ISS is limiting its consideration of a company's updated peer group to situations in which that peer group was used for benchmarking CEO pay for the fiscal year ending prior to the company's 2017 annual meeting.

Meridian Comment. ISS's evaluation of a company's weighted average financial metrics against peer company statistics may prove problematic, as such metrics are significantly affected by capital structure, life cycle and growth rate, among other factors. Therefore, ISS's evaluation of such financial metrics may result in unpredictability in ISS's pay-for-performance assessment. Further complicating matters will be ISS's unusual and proprietary distillation of multiple financial metrics into one weighted measure. Due to the lack of transparency, companies will be unable to determine independently the accuracy of the weighted measure. More significantly, ISS has not provided any evidence that a consolidation of multiple financial metrics into a single metric provides any meaningful information about a company or its peer companies.

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The **Client Update** is prepared by Meridian Compensation Partners' Technical Team led by Donald Kalfen. Questions regarding this Client Update or executive compensation technical issues may be directed to Donald Kalfen at 847-235-3605 or dkalfen@meridiancp.com.

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