Proxy Advisors and Investors Announce How They Will Use CEO Pay Ratios in 2018

The major proxy advisors and three large institutional shareholders announced that CEO pay ratios will have little to no impact on their vote recommendations and vote decisions, respectively, in 2018.

At a recent conference hosted by CompensationStandards.com, David Kokell, Vice President of Institutional Shareholder Services (ISS), stated that **CEO pay ratios will not have any impact on ISS's analysis or vote recommendations in 2018**. However, ISS will include the information in its reports. Similarly, in a recent Glass Lewis blog post, Glass Lewis confirmed that it does not intend to incorporate the pay ratio into its assessment and analysis of Say on Pay proposals in 2018, but also will include pay ratios in its reports.

During an investor panel, representatives of BlackRock and Vanguard confirmed that the pay ratio will be considered as one data point, but neither investor expects that it will factor in their vote determinations in a significant way in 2018. BlackRock said that a reported pay ratio could be a trigger for engagement where the proxy disclosure provides insufficient context. Meanwhile, T. Rowe Price said that the pay ratio will not be used as a data point in its proxy voting model in the near-term.

Meridian Comment. The announcements that the pay ratio disclosures will not inform proxy advisory firm vote recommendations or select institutional investor vote decisions in 2018 are welcome news to U.S. public companies. However, certain institutional investors, such as public pension plans, may use pay ratios to inform their activism, engagement and proxy voting. Furthermore, we expect proxy advisors will, over time, include in their company reports year-over-year changes in a company's pay ratio and comparative pay ratio data of peer companies.

ISS Modifies its Pay-for-Performance Assessment for 2018

Mr. Kokell also announced a material change in ISS's U.S. pay-for-performance assessment that will take effect for the 2018 proxy season. Based on backtesting, ISS expects that the change will effect its evaluation of less than 5% of companies.

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 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). Generally, ISS will perform the Qualitative Analysis in cases where the Quantitative Analysis yields a "medium" or "high" concern level regarding a potential misalignment of pay and performance. 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.

Currently, in its Qualitative Analysis, ISS considers a standardized comparison of a CEO's pay and company financial performance ranking relative to an ISS-determined peer group based on a weighted average of up to seven growth, return and TSR metrics. **For 2018, ISS will include a relative financial performance analysis**

(FPA) in its Quantitative Analysis as a modifier when the existing quantitative tests yield scores near the upper threshold for a "low" concern or the lower threshold for a "medium" concern. The FPA modifier may result in some companies moving from a "low" concern to a "medium" concern and others from a "medium" concern to a "low" concern. Based on feedback that ISS received, ISS will reduce the number of financial measures in the FPA from seven metrics to three or four metrics; however, ISS has not announced those financial decisions.

Meridian Comment. The inclusion of a FPA modifier in the ISS pay-for-performance test will result in less predictability in the quantitative test results. It may also result in some companies drafting proxy disclosures to demonstrate pay-for-performance alignment based on the FPA financial metrics and/or engagement with ISS and/or investors regarding whether the FPA metrics are appropriate for a specific company or industry. In the long-term, an adverse consequence of ISS's new pay-for-performance test may be further homogenization of incentive program designs to focus on select metrics, as we have seen with relative TSR plans.

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