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ISS Announces Methodology Updates to the Pay-for-Performance Assessment Beginning in 2017

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Today, Institutional Shareholder Services (ISS) announced a methodology update to its CEO pay-for-performance assessment for U.S. companies. Beginning February 1, 2017, ISS proxy research reports will include a new standardized comparison of a company's financial performance relative to its ISS-defined peer group.

This is a departure from ISS' sole reliance on Total Shareholder Return (TSR) as a metric. ISS will measure multiple financial metrics which may include Return on Equity, Return on Assets, Return on Invested Capital, Revenue growth, EBITDA growth and Cash Flow (from Operations) growth; these metrics will supplement TSR, but only in the qualitative assessment. ISS will calculate a weighted average of select financial metrics; measures (and weightings) will be based on a company's four-digit GICS industry group. For 2017, the new financial assessment *will not* be included in the quantitative assessment although ISS may incorporate a company's relative financial performance in its qualitative discussion.

This is a significant change to ISS' pay-for-performance methodology which primarily assesses performance based on Relative TSR. While the additional financial metrics will not be included in the quantitative assessment for the 2017 proxy season, it can provide shareholders with additional context of a company's overall financial performance. The implication is that TSR will still drive a company's specific level of concern in the quantitative tests. However, if the company's financial metrics are not aligned with their stock performance, it could weigh heavily on whether they receive a "For" or an "Against" recommendation from ISS on the Say on Pay vote. Examples where this new policy could help a company is if the market has overreacted to news or industry shifts, but the underlying financials are still relatively strong. When ISS releases the details on the definition and weightings of each financial metric, it will be important for a company to model the financial performance relative to the ISS-defined peer group to understand how its performance will be viewed relative to comparators.

With this updated methodology, however, realizable pay will become increasingly more important in a company's overall pay-for-performance assessment. By taking a more holistic look at stock and financial performance, ISS may more appropriately capture the linkage between actual compensation earned and the underlying financial performance.

Additionally, ISS has historically relied on S&P to provide financial data, which does an effective job at creating comparability across companies financials. However, they are typically limited in the adjustments they can make across companies (ISS will likely use GAAP definitions, where applicable) and, therefore, a company's view of its relative performance (which may include adjustments) could differ from ISS. This could be true where there are significant differences between a company's peer group and the ISS peer group, particularly for companies with a cross-industry peer group (which are more commonly used with large cap companies).

In addition to incorporating financial performance metrics, ISS also announced that it will no longer include companies with less than two years of TSR and pay data in the Relative Degree of Alignment (RDA) assessment. This change will only impact newly public companies.