ISS and Say on Pay: Early Impressions
A Murky Methodology Becomes Murkier

By Jon Weinstein and Linda Pappas

The third Say on Pay season is underway and Institutional Shareholder Services (ISS) is continuing to exert its considerable influence on investors through its voting recommendations. While the majority of the proxy season has yet to run its course, initial patterns are emerging from our analysis of ISS Say on Pay recommendations to date – some of which are unexpected and, occasionally, confounding.

While ISS has indeed tried to make some valid attempts to improve its methodology, much of the true self-reflection that is needed at ISS (see Pay Governance Viewpoint #10, *"Say on Pay Soul Searching Required at Proxy Advisory Firms,"* June 2012) has yet to occur. In short, it seems as if the ISS "black box" has become blacker, leaving companies with more questions about ISS' decision-making process than before. This is highlighted by a weakened correlation between a company's result on ISS' quantitative pay-for-performance tests and ISS' overall Say on Pay recommendation: in a recent interview with the *Wall Street Journal,* ISS' Special Counsel reported that in 2012, over 50% of companies with "high" quantitative pay-for-performance concerns received ISS "Against" recommendations vs. only 35% thus far in 2013.

So, if ISS is paying less attention to its quantitative analyses, what are they looking at in making recommendations? Some of our early impressions are as follows:

- ISS appears to be performing rigorous *qualitative* compensation program reviews (e.g., the mix between time-based vs. performance-based LTI, performance metrics, benchmarking practices, etc.) for more companies, even those that score "low" concern on the quantitative pay-for-performance tests (despite initial ISS guidance that such reviews would be focused on "high" and "medium" concern companies). Moreover, the results of these qualitative reviews seem to be having an increased influence on ISS' recommendations and, in some cases, have resulted in recommendations *against* Say on Pay at "low" or "medium" concern companies.

- Also contrary to the guidance it provided earlier in the year, ISS is taking into account *share pledging* policies and arrangements not only for the purpose of evaluating director elections but also for assessing the appropriateness and reasonableness of companies' compensation programs.

- ISS is no longer providing a pass to companies who have *grandfathered change-in-control (CIC) arrangements,* including features such as excise tax gross-ups and single triggers, but who have banned such practices going forward. Rather, criticism is being leveled at companies that maintain "problematic" CIC practices even if they have precluded similar arrangements going forward. While ISS' guidance was supposed to take legacy CIC practices into account only in Say on Golden Parachute votes, ISS seems now to be applying this policy to its Say on Pay assessment criteria.

- Perhaps most troublesome to certain companies, ISS has dramatically raised its *disclosure expectations* for companies that garnered less than 70% Say on Pay support in 2012. For these companies, ISS is criticizing companies who stop short of disclosing specific shareholder feedback and the company's response to such feedback – even if shareholder input is positive or affirmative of the compensation system now in place. Merely to state the occurrence of a shareholder outreach program or dialogues with investors does not seem to be satisfactory to ISS if the outcomes of the discussions are not disclosed in detail – despite the fact that investor input can yield contradictory recommendations.

- While ISS changed its *peer group determination* methodology to incorporate a company's named peers and to reserve the right to relax scope parameters in order to do so more effectively, ISS seems more than ever to be driving the subject company as close to the median of the ISS peer set as possible. It appears to us that ISS' provision that it can relax revenue scope ranges to include additional company peers has often been ignored.

- Finally, unbeknownst to subject companies and ISS subscribers, there seems to be a new, unofficial ISS Say on Pay determination beyond just "For" and "Against" – the "*Qualified For"* recommendation. More than in past years, we have noticed that ISS is adding cautionary notes to its favorable Say on Pay opinions, implying that its support is tentative and ephemeral, and urging shareholders to remain vigilant in the future.

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Last year, much of the ISS-related struggle companies faced was over defined issues where the parties – subject companies and ISS – essentially agreed to disagree (e.g., peer group selection, the use of realizable vs. target pay in assessing pay-for-performance, etc.). This year, however, the challenge has been to understand how ISS is arriving at its conclusions, particularly when they do not seem to be following their own guidance consistently. We fear that the murky ISS methodology has become murkier, and this lack of clear expectations creates an uneven playing field in companies' abilities to address ISS concerns while continuing to motivate executive teams. As a result, even companies with strong pay-for-performance records need to be prepared for a potentially unpleasant ISS surprise.

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