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Meridian Client Update

ISS Modifies Elements of its CEO Pay-for-Performance Test

Institutional Shareholder Services (ISS) recently announced two important modifications to its CEO pay-for-performance test. The first modification alters ISS scoring methodology under its quantitative pay-for-performance tests that may result in slightly fewer U.S. companies showing a pay misalignment. The second modification revises ISS's peer group selection methodology for certain energy companies.

ISS Quantitative Pay-for-Performance Test Thresholds

ISS substantially overhauled its pay-for-performance analysis in advance of the 2012 proxy season. Under this analysis, for Russell 3000 companies, ISS evaluates whether a misalignment exists between CEO total pay and company performance, on both a relative and absolute basis, using three quantitative tests (which have remained unchanged from those adopted in 2012). If the quantitative tests show that a misalignment exists (i.e., the tests return a medium or high overall concern level), ISS will assess the company's pay practices against certain subjective factors to determine whether those factors effectively mitigate or facilitate the misalignment. The outcome of this assessment will impact ISS's vote recommendation on a company's say on pay proposal.

ISS is implementing the following changes to two of its quantitative pay-for-performance tests effective as of February 1, 2015:

- Relative Degree of Alignment (RDA) test. The RDA test measures the degree of alignment between total shareholder return (TSR) and CEO total pay over three years compared to ISS-determined peers. ISS is **lowering** the threshold for a medium concern on its RDA test. This change will **reduce** the number of companies flagged for medium concern under the RDA test.

- CEO Total Pay and TSR Alignment (PTA) test. The PTA test measures the 5-year historical trend in CEO pay and company TSR. ISS is **raising** the thresholds for medium and high concerns under the PTA test. This change will **increase** the number of companies flagged under the PTA test.

The net impact of these changes appears to be a slight reduction in the number of companies showing a CEO pay misalignment.

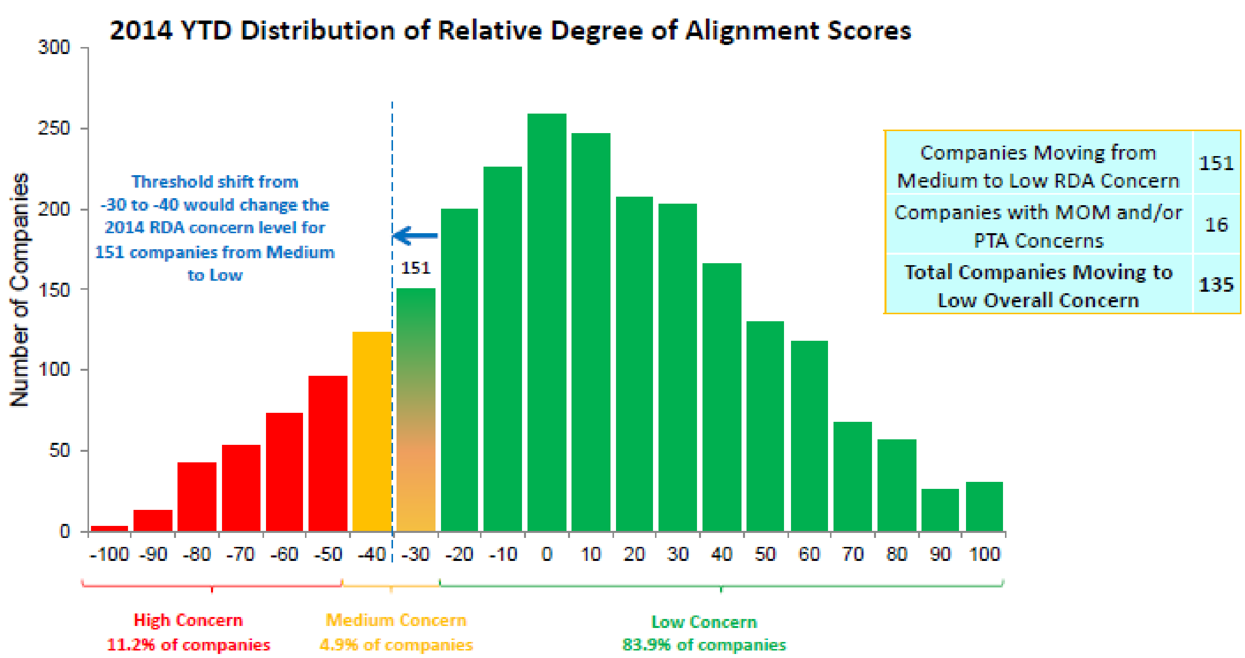
The table below shows the foregoing changes to the RDA and PTA tests.

Quantitative Test	Timeframe & Comparison	Thresholds for meetings before Feb 1, 2015		Thresholds for meetings on/after Feb 1, 2015		Impact
		Medium	High	Medium	High	
Relative Degree of Alignment (RDA)	3 Year – relative to ISS peers	-30	-50	-40	-50	Fewer companies trigger concern
Multiple of Median (MOM)	1 Year – relative to ISS peers	2.33	3.33	2.33	3.33	No Change
Pay-TSR Alignment (PTA)	5 Year – *not* relative to ISS peers	-30	-45	-20	-35	More companies trigger concern

Based on 2014 back-testing, 3.8% fewer companies would have an elevated level of quantitative concern under new thresholds

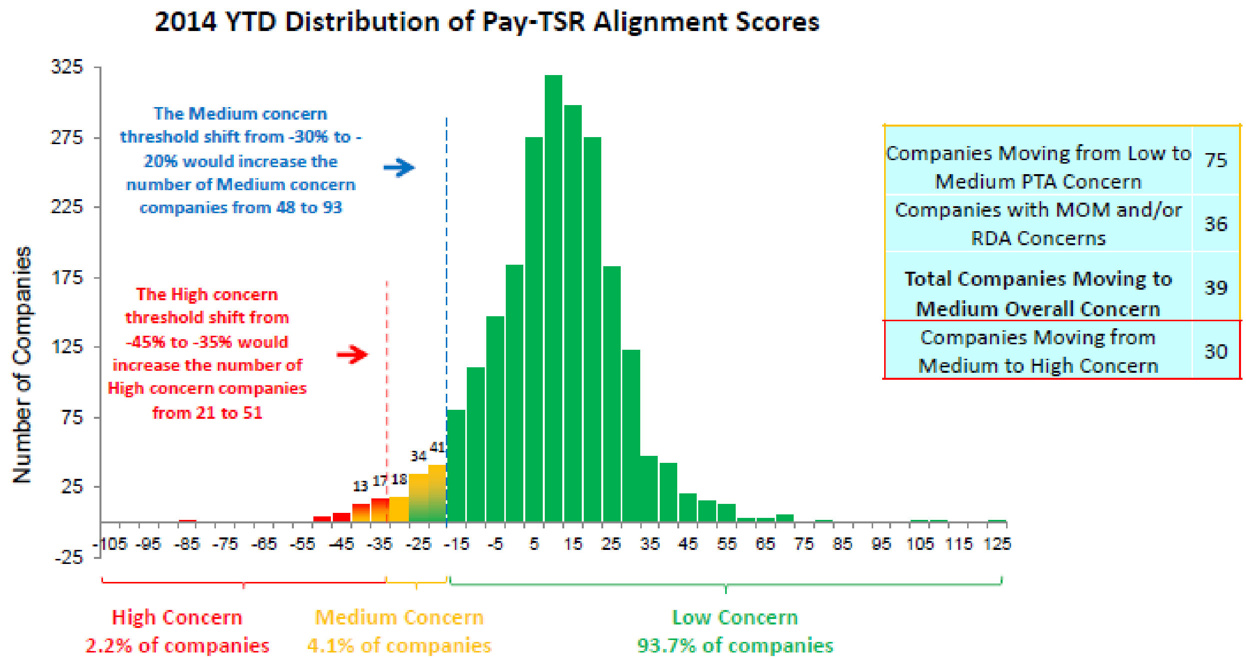
Source: ISS Corporate Solutions

The graphic below shows the impact of changes to medium threshold for the RDA test, the resulting distribution of 2014 RDA scores and the prevalence of the low, medium, and high concern levels.



Source: ISS Corporate Solutions

The graphic below shows the impact of changes to medium and high concern thresholds for the PTA test, the resulting distribution of 2014 PTA scores and the prevalence of the low, medium, and high concern levels.



Source: ISS Corporate Solutions

ISS adjusted the RDA test threshold score due to its finding that the impact of an RDA test was insignificant until the test yielded a score of at least -40. According to ISS, the change in the RDA test threshold for a medium concern level will improve its ability to identify companies with potential pay-for-performance misalignment.

Meridian comment. A potential pay-for-performance misalignment based on ISS's quantitative test arises most frequently due to a medium or high concern on the RDA test. Since the new threshold under the RDA test should trigger a medium or high concern for fewer companies (based on ISS's back testing), the modification of the RDA test appears favorable to companies.

As noted above, when the quantitative tests reveal a potential CEO pay misalignment, ISS will assess a company's pay practices against a number of subjective factors. If this assessment shows that the CEO pay misalignment is facilitated (rather than mitigated) by company pay practices, then ISS would likely recommend an **AGAINST** vote on a company's Say on Pay proposal. **Historically, ISS's subjective assessment has found a potential CEO pay misalignment to be mitigated for 44% and 80% of companies that received high and medium overall concern levels, respectively. Therefore, ISS is likely to issue FOR vote recommendations on most companies' Say on Pay proposals despite a showing of a CEO pay misalignment under the quantitative pay-for-performance tests, especially for medium concern outcomes.**

New ISS Peer Group Selection Methodology for Certain Energy Companies

Two of the quantitative pay-for-performance tests require ISS to develop a peer group for the subject company. A subject company's peer group will generally be composed of 14 to 24 ISS-selected companies. Peer groups are generally constructed with reference to a subject company's industry (based on GICS classification), revenue (or assets with respect to financial services companies) and market cap.

ISS has revised its methodology for developing peer groups with regard to energy companies that fall into one of the following 8-digit GICS groups:

- 10102010 (Integrated Oil & Gas)
- 10102020 (Oil & Gas Exploration & Production (E&P))
- 10102030 (Oil & Gas Refining & Marketing)
- 10102040 (Oil & Gas Storage & Transportation)
- 10102050 (Coal & Consumable Fuels)

For companies in these GICS groups, ISS will select potential peer companies that are **within 0.4× to 2.5× of the subject company's market cap**. Unlike under its methodology for other nonfinancial companies, ISS will **not** consider revenue in developing peer groups for these companies.

In addition, for Integrated Oil & Gas and Oil & Gas E&P companies (GICS 10102010 and GICS 10102020, respectively), ISS will select peer companies solely from within the subject company's 8-digit GICS group and/or the 8-digit GICS groups of its selected peers. Unlike under its methodology for other Russell 3000 companies, ISS will not consider companies within the subject company's or its selected peers' 4-digit and 6-digit GICS groups in developing peer groups for Integrated Oil & Gas and Oil & Gas E&P companies.

Meridian comment. ISS's new methodology for developing peer groups for energy companies will likely result in peers that better reflect a subject company's market capitalization and, in some cases, operations. This change in methodology is likely a result of industry engagement with ISS. Earlier this year, a group of E&P companies discussed with ISS flaws in ISS's peer group development methodology that result from a one-size-fits-all approach. The group explained that revenue was a poor indicator of size within the E&P segment and informed ISS about the differences in business models within the energy industry and the different factors that influence the various industry segments. This is a notable instance in which an industry successfully persuaded ISS to change how it evaluates companies in that industry. The positive outcome indicates that ISS may be more receptive to addressing pervasive issues regarding ISS policies through collective action by industry constituents rather than through individual company engagements.

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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.