ISSUE 2014-1
JANUARY 27, 2014

Meridian Compensation Partners Client Update

Understanding How Institutional Shareholder Services (ISS) Evaluates Pay for Performance

For TSX Composite Index companies, ISS will recommend voting “against” say on pay, “withhold” on directors, and/or “against” an equity plan proposal if:

- There is significant misalignment between CEO pay and company performance,
- The company has problematic pay practices, or
- The Board communicates poorly or is not responsive to shareholders.

ISS conducts a three part quantitative evaluation and a qualitative assessment of the alignment between CEO pay and company performance. Understanding how the ISS tests work and anticipating the results allows companies to be proactive in:

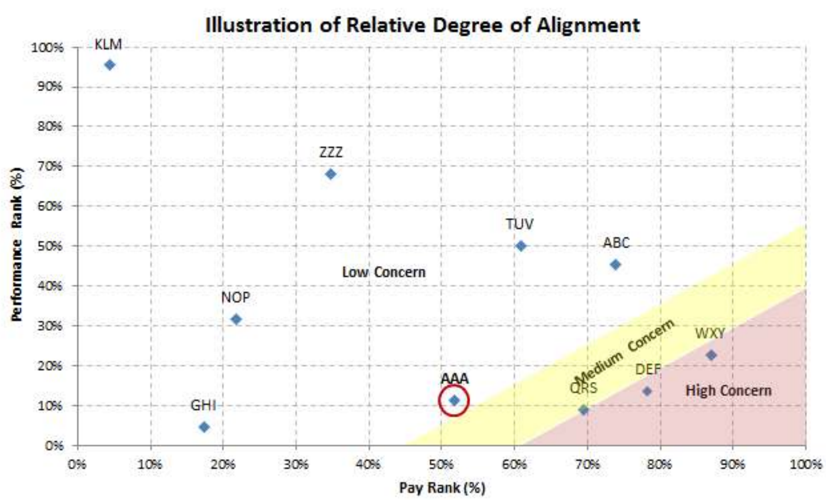
- Drafting disclosure to make a compelling case for their pay for performance story and to facilitate a favourable qualitative review by ISS
- Engaging with shareholders to counter a potential negative ISS vote recommendation

Meridian Comment: An ISS against vote recommendation correlates with significantly reduced shareholder support of say on pay. The ISS vote recommendation can impact 25% to 30% of the vote results, depending on a company’s shareholder base.

Three Part Pay for Performance Quantitative Screen

The quantitative analysis assesses CEO pay for performance based on three tests:

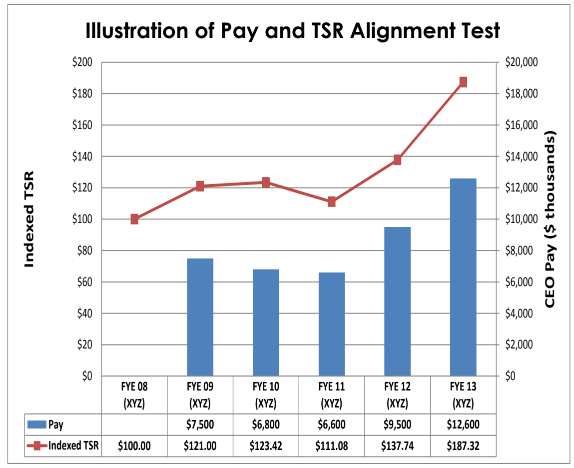
1. **Relative Degree of Alignment (RDA)** — This test compares total shareholder return (TSR) and CEO pay[1] relative to an ISS developed peer group, over a 3 year period. High relative TSR and high pay would be aligned. Low relative TSR and high pay would not be aligned.



[1] Total pay as reported in the Summary Compensation Table, based on grant date fair value of equity awards.

2. **Multiple of Median (MOM)** — This test measures the multiple of the CEO's one-year pay relative to ISS' peer group median pay, without regard for performance.

3. **Pay TSR Alignment (PTA)** — This test measures CEO pay against the company's own TSR over the previous 5 years. Pay will be aligned if it increases and decreases as TSR increases and decreases.



ISS will determine an overall concern level (i.e., "high", "medium", or "low" concern) based on results from the three tests. A medium or high concern does not automatically lead to an adverse vote recommendation, but increases the rigor of the qualitative analysis and the likelihood of a negative recommendation.

Meridian Comment: The RDA test is changed for 2014 and now looks only at alignment over a three year period. In prior years, ISS considered 3 year alignment (weighted 60%) and 1 year alignment (weighted 40%). The ISS focus on grant date fair value for equity compensation is a significant potential source of pay and performance misalignment. More companies are providing disclosure of realized/realizable pay to support CEO pay and performance alignment.

Peer Group Selection

In conducting the RDA and MOM tests, ISS develops a peer group of 11-24 companies using the following criteria:

- Revenue between 0.25× and 4× the subject company's size
    - Assets are used for financial companies
- In the closest GICS industry group (8-, 6-, 4-, or 2-digit) to the subject company's GICS category
- Market cap *within a range that varies according to the subject company's market cap*
- If 11 companies that meet these criteria cannot be identified, the revenue criteria (but not the market cap criteria) will be relaxed, and companies from different GICS industries may be considered

ISS considers a company's self-selected peers in exceptional cases only in order to reach the minimum peer group size.

Meridian Comment: The appropriateness of the ISS peer group is a frequent source of criticism of the ISS quantitative tests. ISS' mechanical peer group selection process in accordance with the methodology described above does not incorporate other important factors that Boards consider when developing benchmarking peer groups, such as competitors for executive talent.

ISS Qualitative Review

In addition to the three quantitative screens, ISS performs a qualitative review that may include the following:

1. Ratio of performance-based to time-based equity awards – ISS expects at least 50% of equity to vest (or be awarded) based on performance criteria. However ISS does not consider time-vested options to be performance based.
2. Overall ratio of performance-based compensation to total compensation.
3. The quality of disclosure and rigor of performance measures and goals – ISS has raised an issue that performance targets are not sufficiently challenging when there is a history of above target payouts.
4. Peer group benchmarking practices – ISS looks at whether the peer group is appropriate in terms of size and whether pay is targeted around (or below) median.
5. Trend in financial metrics other than total shareholder return – companies may wish to disclose their performance relative to other metrics where TSR does not tell the whole story.
6. Trend from prior years' pay for performance concern – i.e., whether the company has taken steps to address concerns ISS identified in prior years.
7. Special circumstances – i.e., a new CEO hire in the last fiscal year or unusual equity grant practices.

ISS Problematic Pay Practices Policy

The following are examples of compensation practices ISS considers problematic:

- Poor disclosure such as omitting the rationale for compensation setting and outcomes or material contracts and agreements
- New CEO with overly generous new hire/promotion package (so called "golden handshakes")
- Employment contracts with multi-year guaranteed salaries, bonuses or equity grants
- Interest free or low interest loans
- Excessive severance or change in control provisions, including severance in excess of 2× cash compensation, single trigger CIC cash severance or equity vesting
- Abnormally large bonus payouts without justifiable performance or disclosure
- Egregious pension/SERP payouts (including extra service years without compelling reason)
- Excessive perquisites or tax gross-ups
- Dividends paid on unearned performance shares or units
- Problematic option grant practices such as backdating, spring loading or re-pricing
- Excessive internal pay disparity between the CEO and the next highest named executive officer
- Absence of compensation risk mitigators such as clawbacks and executive share ownership requirements

Board Communications and Responsiveness

ISS will also consider the following when evaluating executive pay:

- Poor disclosure practices
- Board responsiveness to investor input and engagement on compensation issues (i.e., a failure to respond to a say on pay vote result of less than 70% in favour—a "yellow card")

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