

Understanding the Impact of ISS' Multiple of Median Test on Say on Pay Vote Support

Our weekly Say on Pay report often raises interesting questions about what the data really mean. These questions are addressed in this series. All of our Say on Pay materials can be accessed at www.semlerbrossy.com/sayonpay.

Introduction

Our weekly Say on Pay research consistently demonstrates that vote support is, on average, meaningfully lower (28%) when Institutional Shareholder Services (ISS) recommends “against” an issuer’s Say on Pay proposal. And, while ISS will conduct a thorough qualitative review before issuing an “against” recommendation, we know that ISS’ three quantitative tests are used as a preliminary screen to determine the level of qualitative scrutiny applied. Further, ISS has reported that 80% of all “against” recommendations issued in 2014 identified one or more quantitative pay-for-performance concerns, suggesting that these initial screens can be strong predictors of the potential for an ISS “against” recommendation. Here we explore the impact of just one of these three quantitative tests – the Multiple of Median (MoM) test.

Background

ISS’ MoM test examines the subject company’s CEO pay as a multiple of the median CEO pay for its ISS defined peer group in the most recent year. The MoM test serves to identify companies where the absolute quantum of CEO pay is high relative to the peer group and complements ISS’ other quantitative pay-for-performance tests which examine the sensitivity of pay decisions to absolute and relative total shareholder return (TSR) performance. Each of the tests is scored with a “low,” “medium,” or “high” concern and “medium” or “high” concerns on one or more of the tests will trigger ISS’ qualitative review.

A November/December update from ISS’ Corporate Solutions advisory group notes that 10% of the companies that received an “against” recommendation in 2014 had isolated MoM-related concerns (i.e., received “low” concern on the other quantitative pay-for-performance tests). While this percentage is modest in comparison to the Relative Degree of Alignment test (which was identified as the singular quantitative concern in 47% of ISS’ 2014 “against” recommendations), it is of particular interest because it is the only component of ISS’ quantitative tests that examines only the most recent year’s pay. As such, it is more sensitive to the impact of one-time pay actions such as “mega-grants” of equity which may be awarded for any number of reasons (e.g., new hire replacement grants, new hire staking grants, retention, etc.).

To gain further insight into the impact that the MoM has on the final ISS recommendation, we have studied 32 Russell 3000 companies that received a “medium” or “high” concern on the MoM test and a “low” concern on the ISS’ other two tests. Our sample covers Say on Pay proposals in 2012 (n=8), 2013 (n=13) and 2014 (n=11).

Say on Pay vote results based on SBCG research of Russell 3000 companies as of December 31, 2014.

Key Findings

Our first finding is that the co-existence of MoM-related concerns and: (i) problematic practices¹ or (ii) three or more unfavorable practices² is very likely to lead to an “against” recommendation from ISS. This finding aligns with the notion of ISS’ approach to use the quantitative tests as a screening mechanism for more thorough qualitative reviews and is consistent with our anecdotal experience with quantitative concerns identified by the other pay-for-performance tests.

Prevalence of Problematic and Unfavorable Practices

ISS VOTE RECOMMENDATION	1+ PROBLEMATIC PAY PRACTICES		3+ UNFAVORABLE PAY PRACTICES		0-2 UNFAVORABLE PAY PRACTICES	
For (n=8)	0	(0%)	0	(0%)	8	(100%)
Against (n=24)	9	(38%)	18	(75%)	6	(25%)
Total (n=32)	9	(28%)	18	(56%)	14	(44%)

In addition to the observed quantitative pay-for-performance disconnect, the rigor of performance goals (63%), benchmark practices (46%), and “mega-grants” of equity (42%) were the most frequently cited factors as contributing to an ISS “against” recommendation.

Prevalence of Unfavorable Factors Cited in ISS “Against” Recommendations

ISS MoM CONCERN	RIGOR OF GOALS	BENCH-MARKING PRACTICES	SPECIAL/ MEGA-GRANTS	NON-PERF BASED EQUITY	RESPONSE TO PRIOR VOTES	SEVERANCE AGMTS.
Medium (n=8)	7	3	3	3	2	1
High (n=16)	8	8	7	6	4	2
Total (n=24)	15	11	10	9	6	3
Prevalence	63%	46%	42%	38%	25%	13%

As previously noted, the nature of the MoM test can lead to results that are highly sensitive to one-time pay actions. Where a “mega-grant” was a significant contributing factor in increasing the MoM score from a “low” concern to a “medium” or “high” concern (12, 38% of total sample), ISS was keenly focused on the grants’:

- Performance-orientation (i.e., time-based vs. performance-based vesting)
- Vesting period
- Pay-for-failure safeguards (e.g., forfeiture upon separation)
- Double-trigger provisions upon CIC

ISS ultimately recommended “against” ten of the twelve companies with a “mega-grant” and eight of these ten companies ultimately failed their Say on Pay proposal. Of the ten companies that received an “against” recommendation, 50% employed time-based vesting for their “mega-grant,” 30% were cited as lacking

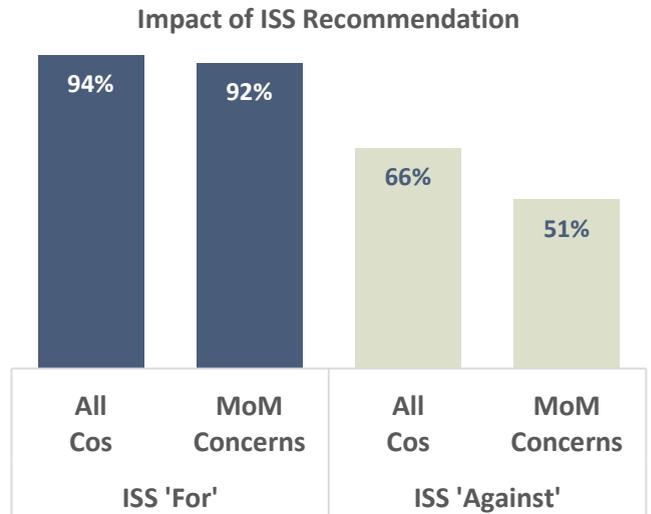
¹ ISS identifies the following as problematic pay practices that are likely to trigger an “against” recommendation: (i) repricing or replacing of underwater stock options without shareholder approval; (ii) excessive perquisites or tax gross-ups; and, (iii) new or extended change-in-control agreements that contain: cash severance of more than three times base salary and bonus, single-triggers, or excise tax gross-ups.

² ISS identifies the following as unfavorable pay practices that may trigger an “against” recommendation: (i) multi-year guaranteed bonuses; (ii) a single or common performance metric used for short- and long-term plans; (iii) lucrative severance packages; (iv) high pay opportunities relative to industry peers; (v) disproportionate supplemental pensions; and (vi) mega annual equity grants that provide unlimited upside with no downside risk.

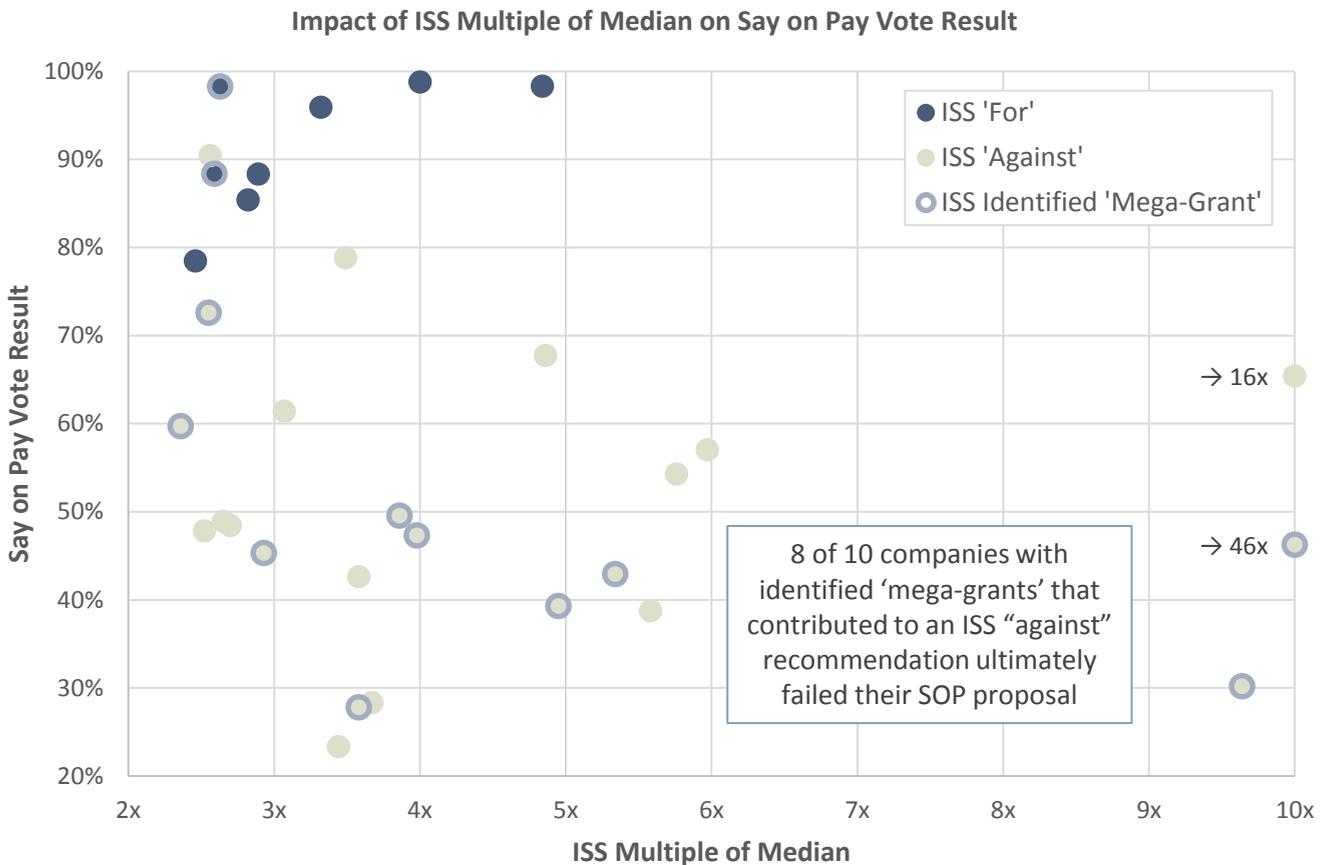
sufficiently rigorous performance goals, and the remaining 20% had other unfavorable pay practices. ISS noted the following as negatively impacting the rigor of performance goals: stock price hurdles that were below the price on the date of grant, performance goals that allowed for early/accelerated vesting, and re-testing provisions that allow for multiple opportunities to earn the shares.

An additional finding is that MoM-related concerns translate to a slightly lower level of vote support when ISS recommends “against” the proposal. Of the 24 companies in our sample that received an “against” recommendation from ISS, average vote support was 51% – which is actually lower than the vote support we see more broadly for companies that received an “against” recommendation from ISS (66%). The same is not true when ISS recommends “for” the proposal.

Slightly less than half of the companies in our sample (47%) failed their Say-on-Pay votes. Of the companies that failed, all received an “against” recommendation from ISS and nearly all of those companies received a “high” concern on the MoM test.



More broadly though, vote support levels do not appear to be correlated with the MoM score – irrespective of ISS’ recommendation “for” or “against” the proposal.



Conclusions

Consistent with our anecdotal experience with the other quantitative pay-for-performance tests, a “medium” or “high” concern on the MoM test is likely to result in an “against” recommendation when combined with any of the practices that ISS deems to be problematic. In the absence of problematic practices, companies are also at an increased risk for an “against” recommendation if the MoM-related concerns are accompanied by three or more unfavorable practices.

While increasing MoM scores do not necessarily have a correlated relationship with vote results, companies with a “high” concern are more likely to receive an “against” recommendation from ISS and, moreover, investors appear to be more punitive when MoM-related concerns are cited by ISS. This is particularly true when the MoM-related concerns have been triggered by a “mega-grant” that ISS deems to be poorly structured (e.g., delivered in time-based vehicles and/or allow for a pay-for-failure scenario).

Issuers that find themselves in a situation where a one-time, “mega-grant” is likely to result in a “medium” or “high” concern on ISS’ Multiple of Median test should proactively engage with shareholders to communicate the rationale for the size and structure of the one-time, “mega-grant.” This dialogue can, in turn, be extremely helpful in identifying how to best communicate the award in the company’s CD&A for shareholders and proxy advisors alike.

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