ISS' NEW 'PAY-FOR-PERFORMANCE' EVALUATION APPROACH - A CHECKLIST

In early May, ISS Australia’s Executive Director and Head of Research, Vas Kolesnikoff, announced the implementation path for ISS’ “pay-for-performance” quantitative analysis model of the ASX300 constituents.

This is a significant announcement. The implications should be well understood by board directors and executives. ISS is the world’s largest proxy adviser, and already uses this quantitative analysis model in UK, Canada, US and much of Europe.

In brief, the results of ISS’ quantitative pay-for-performance evaluation of each of the ASX300 companies will be reflected in its proxy adviser reports and data provided to institutional investors. ISS’ reports and/or data are used by many investors as the basis for determining how they will vote on the remuneration report, director elections, and executive director equity grants.

This evaluation will be in ISS research reports for ASX300 companies that have their AGM on or after 1 October 2017.

**Understanding ISS strategy**

It is important for directors to understand where ISS is coming from in terms of business strategy, and how this differs from other proxy advisers.

ISS’ business is primarily data driven. This lends itself increasingly to automation and lower costs. While lower costs can be utilised for higher margins in providing governance advisory services to investors, this is unlikely to be the basis for ISS’ business model in future. Instead, it will continue to offer investors global proxy advisory services at low price points to maintain, or even increase, its global market share.

In addition, the decades-long trend to index funds lends itself to the provision of services
based on data, rather than issuer engagement and the exercise of human judgement on issuers’ governance. This is because index funds, which are experiencing significant growth in assets under management, allocate a much broader range of securities than active managers. Their own models of stewardship rely on an automated assessment of data feeds from ISS (as well as Glass Lewis) for voting to keep their costs low and margins high.

This US-centric approach makes little provision for substantive engagement with issuers on governance matters (note that this is a generalisation, as some, like BlackRock, see engagement as essential to improve returns on securities that it has to hold because of its size).

In one sense, the ISS global strategy is not well suited to Australian capital markets where superannuation funds still expect proxy advisers to substantively engage with issuers. However, do not forget that almost 40% of larger ASX-listed stocks are owned by foreign interests (and why not, given 26 years of no recessions?). These foreign interests subscribe to either ISS or Glass Lewis, and sometimes both. This means Australian issuers wanting better vote outcomes are well-served to understand the nature of ISS proxy advice.

Maintaining ISS global dominance as a proxy adviser for little profit complements the firm’s strategy to leverage off this dominance by simultaneously providing services to issuers on improving their governance assessments. ISS does this either directly or through agents, such as major audit firms, which also subscribe to their services. It is this governance advisory service that provides the real margins and cash flow that underpin the ISS business. It was the global roll out of the US business model reliant on governance services to issuers, rather than investors, to generate their profits that was the basis for the high priced private equity acquisition of ISS from MSCI.

As predicted (see HERE), ISS has been actively selling its Corporate Services to Australian and other non-US issuers since its acquisition by private equity (see HERE).

**What is the ISS pay-for performance evaluation?**

Australia is one of the last major capital markets in which ISS has rolled out its “pay-for performance” reporting.

ISS’ quantitative analysis of CEO pay for performance is based on three analyses:

- Relative Degree of Alignment: the CEO’s pay and the company’s TSR over three years will
be ranked against the same measures of a comparator group of companies by industry and size.

- **Multiple of Median**: this is another relative measure and ranks the CEO’s pay against the median CEO pay of the comparator group.

- **Pay-TSR Alignment**: this measure is an absolute comparison of the CEO’s pay over the last five years against the value of a notional investment over the same period.

ISS has indicated the comparator group for these purposes will be a group of 11 to 24 companies that are “reasonably similar to the subject company in terms of industry profile and market capitalisation”.

ISS’ Vas Kolesnikoff has said that this type of evaluation will provide institutional investors with actionable insight to gauge the company’s remuneration packages.

These types of measures can be blunt tools and not properly reflect either the company’s performance or the basis of the CEO’s pay. Board directors will want to understand well before their AGM how their company’s performance has been tracking on these measures and what have been the pay movements of the CEO.

**What are the issues?**

The main problem is that the ISS P4P methodology is not well-suited for assessing Australian issuer executive remuneration. Despite the size of Australia’s capital market, most industries are oligopolies. Equity analysts, boards and their remuneration advisers would be hard pressed to find 6 peers to validly compare performance. Yet ISS’ methodology relies on “11 to 24” peers.

In addition, as Guerdon Associates’ articles over more than a decade have pointed out, relative TSR outcomes depend as much on the start point as the end point. Most CEOs would never admit it, but sometimes Blind Freddy can deliver fantastic TSR results if he/she happened to be the last person standing at the bottom of the carnage that also marked the beginning of a performance cycle. Yet, the ISS relative TSR P4P outcomes will be used by a significant number of overseas investors, and local subscribers, to evaluate issuer governance and vote on remuneration and director election matters.

The other concern for many ASX300 companies might be that ISS’ client base is largely foreign investors who are not always easily engaged and may follow ISS proxy advice without
a more informed engagement with the company. This has not been helped by recent significant turnover in the governance teams at major overseas institutional investors this past year.

Observers in the US have also raised concerns around the perceived conflict of interest. A US Government Accountability Office (GAO) study in 2007 noted significant conflicts of interest in ISS’ business model:

“ISS advises institutional investors how to vote proxies and provides consulting services to corporations seeking to improve their corporate governance. Critics contend that corporations could feel obligated to retain ISS’ consulting services in order to obtain favorable vote recommendations.”

ISS Corporate Solutions is a subsidiary of the parent ISS that provides issuer services. Concerns have been expressed both overseas and, more recently, in Australia about ISS Corporate Solutions providing advice to listed companies on the governance measures that are the subject of ISS institutional investor proxy advice (see HERE).

What should you do? A checklist.

1. Assess who your investors are? Who are foreign? Separately, who are ISS subscribers? And importantly, what proportion of stock, and therefore votes, do they hold?

1. Undertake your own quantitative P4P assessment before finalising the FY17 remuneration report.

1. Articulate and present the narrative on your remuneration outcomes, performance, structure and philosophy. Specifically, identify “issues” that an ISS P4P assessment will report, whether valid or not.

1. While a narrative is a reasonable approach for ISS Australian clients, especially if they subscribe to one of the other two proxy advisers’ reports, it will be insufficient for overseas investors who go by the ISS recommendations or numbers. Unfortunately, there is more work involved in getting to ISS overseas clients. To that end, some boards anticipating difficulty in getting through to overseas investors may consider engaging a proxy solicitation firm.

Concluding remarks
ISS’ quantitative evaluation assessment will not necessarily provide investors with a valid assessment of P4P, or of the board’s thinking and rationale for the remuneration structure it has in place. Generally, board directors will have done a lot of work on the remuneration and settled on the framework and structure for good reasons. These need to be clearly articulated and mutually understood to ensure investors do not only get one side of the picture.

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