Center On Executive Compensation

November 1, 2018

**VIA EMAIL**

Mr. Marc Goldstein
Head of U.S. Research
Institutional Shareholder Services, Inc.

**RE: Center On Executive Compensation Comments on 2019 Proposed Policy Update**

Dear Mr. Goldstein:

The Center On Executive Compensation ("Center") is pleased to submit its comments on Institutional Shareholder Services, Inc.'s ("ISS") proposed methodology change, "*ISS Pay for Performance Model – Financial Performance Assessment Methodology (secondary screen).*"

The Center is a research and advocacy organization that seeks to provide a principles-based approach to executive compensation policy from the perspective of the senior human resource officers of leading companies. The Center is a division of HR Policy Association, which represents the chief human resource officers of over 375 large companies, and the Center's more than 135 subscribing companies are HR Policy members who represent a broad cross-section of industries. Because senior human resource officers play an important role in supporting the compensation committee, we believe that our Subscribers' views are particularly helpful in better understanding how executive compensation plans are developed and executed, especially in the post-say on pay era.

Following are our responses to the specific questions presented in the "Request for Comment" section of the description of the proposed change. We have also provided additional commentary on the implications of the change and the conditions we believe are necessary for an equitable implementation of this new methodology.

**Question 1**

"*Under this proposed update, the framework of the primary ISS pay-for-performance model methodology is unchanged and will continue to use TSR as its main performance metric. Does your organization agree with that approach? If not, please explain.*"

The Center has consistently advocated against the use of any predefined measure – including TSR - as the sole measure of performance for every company. We believe that ISS should use the performance metrics identified by each company in its proxy – not the "one-size-fits-all" approach embodied in the current methodology.

With that fundamental caveat, the Center agrees that, given the choice between using EVA or TSR as the main performance metric, ISS should continue to use TSR as its main performance metric.

As we noted in our survey comments, the reason for this position is that the Center's Subscribers are concerned that the calculation of EVA is not yet standardized and there are many nuances to methodologies around this metric that would render its use in an ISS quantitative screen confusing at best and misleading or inaccurate at worst. Further, since very few companies currently use EVA as an incentive plan metric, it would not be an intuitive framework from a company perspective.

**Question 2**

"*If the existing FPA screen performance measures are replaced with EVA-based measures, would you prefer that ISS continue to display GAAP performance data for informational purposes?"*

As we indicated in our September 21 response to your 2019 Policy Survey, the Center believes that if EVA is going to be used, it should ***supplement rather than replace*** GAAP-based measures and TSR. However, if ISS replaces existing FPA screen performance measures with EVA-based measures, we believe that GAAP performance data should continue to be displayed.

**Additional Concerns – Transparency and Transition**

*Transparency*

Our most significant concern regarding the proposed methodology change is the fact that, while GAAP metrics are not perfect, they have a clear and compelling advantage over EVA because they are standardized. This means that companies and investors can trust that there is consistency in their application. While EVA is a robust metric and can be useful in understanding the performance of companies, it cannot and should not be used to evaluate performance (and its relationship to pay) unless the details of the calculation – including all assumptions and methodologies – are transparent and disclosed to issuers and investors. Only then can users be sure that the methodology is being applied consistently and equitably.

Stern Stewart & Company, the originators of EVA, proposed up to 150 potential adjustments to GAAP financials that can be made in calculating EVA.[1] The Center would pose several questions regarding how these adjustments will be handled:

[1] Stewart, Bennett. *The Quest for Value: A Guide for Senior Managers.* HarperCollins Publishers, 1991.

- Does ISS intend to use all 150 of those adjustments?
- If not, which adjustments will be made and how will you decide?
- Will the adjustments be made consistently for every company in every industry, or will there be differences?

Without clear answers to these questions, the calculation of EVA will be subjective and its credibility suspect. The only way to prevent this subjectivity is for ISS to provide a detailed and specific reconciliation of the EVA calculation to the underlying GAAP financials from which it was derived. In addition, all assumptions and inputs used in the cost of capital calculation must be disclosed.

*Transition*

As we noted in our response to the 2019 survey, we support the use of metrics like EVA that take into account both profit and the cost of capital used to generate that profit. Many finance professionals and academics embrace the concepts behind EVA, citing its usefulness in evaluating performance and its link to value creation. However, regardless of the intellectual appeal of EVA and its empirical relationship to value creation, the fact is that EVA is not broadly used by companies to manage performance or to determine pay.

For this reason, we strongly recommend that ISS consider a more thoughtful, multi-year transition approach to using EVA in its pay for performance methodology, allowing issuers and investors adequate time to understand the calculation so that they may put the results in proper context.

**Conclusion**

The Center suggests that if ISS seeks to foster an improved connection between pay and performance, it should embrace the opportunity to build a thorough understanding of EVA among issuers and investors. We believe that this requires the following:

- Full and complete disclosure of the EVA calculation methodology, including all adjustments made to GAAP financials, and the detailed assumptions and inputs used to calculate a company's cost of capital.
- A reasonable transition period where the current GAAP financial metrics used in the pay for performance screen are retained and EVA is used as a supplemental metric.

The Center On Executive Compensation appreciates the opportunity to submit its views on this proposed change. Please do not hesitate to contact us at ahuang@execcomp.org or scarlin@execcomp.org if you have any questions about our comments or would like to discuss them further.

Sincerely,

Ani Huang
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