ISS Issues White Paper Outlining New Methodology for Evaluating Pay-For-Performance

Overview

On December 20th Institutional Shareholder Services (ISS) issued a white paper outlining its new approach to evaluating pay-for-performance in 2012. A pay-for-performance disconnect was the single most important factor in ISS' decision last year to recommend a "No" vote on management's say-on-pay proposal. Understanding how ISS reaches its conclusion will be important for companies both in designing pay packages as well as in crafting disclosure that tells the company's side of the pay-for performance story.

The new methodology begins with a quantitative assessment that identifies pay-for-performance disconnects based on relative CEO pay and performance versus peer companies over one- and three-year periods and an absolute evaluation of CEO pay trends versus total shareholder return (TSR) performance over a five-year period. The quantitative evaluation is followed by an in-depth qualitative review to determine the cause of the disconnect and to identify any mitigating factors.

The white paper, which can be found here, provides extensive information on the methodology along with appendices detailing how peer groups are constructed and the regressions used to calculate pay and performance alignment. A summary of the methodology follows.

Quantitative Assessment

What ISS Measures

ISS will continue to use total CEO compensation as reflected in a company's summary compensation table. ISS will take into account all elements of reported pay, but will use a standard set of assumptions (not described) to value equity-based awards. For performance, ISS will continue to use TSR as the primary metric but will use three separate measures of alignment between executive pay and company performance – two relative measures (where pay-for-performance alignment is evaluated in reference to a group of comparable companies) and one absolute measure (where such alignment is evaluated independently of other companies' performance).

Measures of Relative Alignment

Relative Degree of Alignment (RDA) takes the percentile rank of a company's CEO pay and TSR performance within an ISS selected comparison group of 14 to 24 companies (the determination of this comparison group is discussed below) over one- and three-year periods and then combines them (weighted 60% for the three-year ranks and 40% for the one-year ranks) to produce a single RDA score (ranging from -100 to 100) equal to the difference between the combined TSR percentile and the combined CEO pay percentile. An RDA of zero represents a high degree of alignment.

Multiple of Median (MOM) expresses the CEO's pay for the prior year as a multiple of the median pay of the CEOs of the comparison group for the same period. The MOM score is calculated by dividing the company's CEO pay by the median CEO pay for the comparison group.

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Measure of Absolute Alignment

Pay-TSR Alignment (PTA) is calculated as the difference between the slopes of weighted linear regressions for pay and for TSR over a five-year period. This difference indicates the degree to which CEO pay has changed more or less rapidly than shareholder returns over the period. PTA does not measure the sensitivity of CEO pay to performance (i.e., whether pay and performance go up and down together on a year-over-year basis) but, instead, is intended to be a long-term measure of alignment.

Overall Score

A company's three scores, RDA, MOM and PTA, are reviewed to determine whether the company should receive a High, Medium or Low concern level for the quantitative component of the pay-for-performance evaluation. The following table shows the levels at which ISS would consider a company to be an outlier (triggering Medium concern) or a significant outlier (triggering High concern). High concern for any individual factor will result in an overall High concern level for the quantitative component of the pay-for-performance evaluation, and multiple Medium concern levels may also result in an overall High concern level. The RDA measurement is effectively weighted most heavily in this analysis.

Measure	*Level that may trigger High concern in conjunction with other measures*	*Level that triggers High concern by itself*
RDA	-30 ~25th percentile	-50 ~10th percentile
MOM	2.33x ~92nd percentile	3.33x ~97th percentile
PTA	-30% ~10th percentile	-45% ~5th percentile

According to ISS, based upon back-testing of its new quantitative methodology on 2,500 companies for the years 2006 through 2010, each of the three measurements produces a normal distribution of results and all three measurements are statistically significant predictors of say-on-pay voting results, with the strongest correlation coming from the RDA measurement.

Qualitative Assessment

When the quantitative analysis reveals that pay and performance appear disconnected, ISS will undertake an in-depth qualitative assessment of the company's various pay elements and how they may be working to encourage, or undermine, long-term value creation and alignment with shareholder interests in order to determine the likely cause, or mitigating factors, for the quantitative results. In conducting this in-depth analysis ISS will consider one or more of the following:

Strength of Performance-Based Compensation. ISS may evaluate the ratio of performance- to time-based equity awards and the overall ratio of performance-based compensation to total compensation. ISS would expect that a company exhibiting significant misalignment of pay and performance would strongly emphasize performance-based compensation and would fully disclose performance metrics and goals that are reasonably challenging to achieve. ISS would also likely identify concerns if a company uses only a single metric, or similar metrics, for either or both of the company's short- and long-term incentive programs.

Peer Group Benchmarking Practices. ISS may also examine a company's disclosed benchmarking approach to determine whether it is a contributing factor to pay-for-performance misalignment, including by

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driving up compensation through the use of self-selected peers that are larger than the subject company or by targeting compensation levels above the median.

Results of Financial/Operational Metrics. ISS may consider the rigor of performance goals (if any) that generated the payouts resulting in the misalignment of pay and performance to determine whether the quantitative analysis may be anomalous (if other metrics suggest sustained superior performance).

Special Circumstances. The qualitative analysis may also consider exceptional situations, such as recruitment of a new CEO in the prior fiscal year or unusual equity grant practices (e.g., large, multi-year awards) that may distort a quantitative analysis.

Determination of the Comparison Group

ISS will select a comparison group of between 14 and 24 companies based on industry profile, size and market capitalization, which will be updated semiannually, as of December 1 and June 1 of each year, based on the subject company's revenue for the most recent trailing 4 quarters, total assets as of the end of the most recent quarter and market capitalization based on a 200-day average share price.

The peer group companies are selected from a pool of companies sharing the same 2-digit Global Industry Classification Standard (GICS) code and having between 0.45 times and 2.1 times the subject company's annual revenues (assets for financial companies) and between 0.2 times and 5 times the subject company's market capitalization. From this universe of companies, ISS selects companies that are in the subject company's 6-digit GICS category, first selecting the companies closest in size (i.e., revenue or assets) and, where possible, alternating between companies larger and smaller than the subject company so as to maintain the subject at or near the median of the chosen comparison group. The goal is to have between 14 and 24 companies selected from the 6-digit GICS category. If the minimum 14 companies is not met in the subject company's 6-digit GICS category, the process is repeated with companies that share the subject company's 4-digit GICS category, until 14 comparison companies are selected. Again, if 14 comparison companies cannot be selected using the 4-digit GICS category, the process is repeated using the 2-digit GICS category. Where the standard comparison group methodology fails to identify a minimum of 14 companies, the revenue (but not the market capitalization) parameter will be relaxed to enable ISS to select a comparison group of 14 companies. In addition, for companies with over $50 billion in revenue and at least $30 billion in market capitalization, ISS has created a "super-mega" comparison group that reflects the fact that these companies typically have few or no industry peers close to their size.

We suspect that one of the key questions compensation committees will want to ask their independent compensation consultants is whether they have the tools to replicate the ISS quantitative methodology. It will be an important part of the overall planning process for a company's compensation program design and proxy disclosure.

Please contact your usual Ropes & Gray adviser with any additional questions about ISS's new approach to evaluating pay-for-performance.

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