

ISS 2013 Realizable Pay and Quick Score

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In January, 2013, Institutional Shareholder Services (ISS) made two announcements of note related to executive compensation

1. **Realizable Pay:** Updated the Evaluating Pay for Performance document to provide a detailed description of its methodology for calculating realizable pay
2. **QuickScore:** Rolled out QuickScore as a replacement for its GRId score

REALIZABLE PAY

For S&P 500 CEOs at companies with an annual meeting after February 1, 2013, the standard ISS research report will show three-year total realizable pay in addition to the three-year total grant date pay that is used in its quantitative analysis. If a company's quantitative test results in a medium or high level of concern, ISS will discuss realizable pay levels vs. grant date pay as a part of the qualitative review. If realizable pay is significantly lower than grant date pay, it could be a potential indicator that the actual pay-for-performance relationship is more aligned than the quantitative analysis indicates.

Conversely, if realizable pay is greater than grant date pay in a company whose quantitative analysis results in a medium or high level of concern, it may aggravate concerns about the pay for performance

In January, 2013, Institutional Shareholder Services (ISS) made two announcements of note related to executive compensation: Realizable Pay and QuickScore.

Although there are still some limitations to realizable pay analysis (discussed further below), we believe that, on an overall basis, this brings ISS' analysis one step closer to assessing the true pay-for-performance relationship.

ISS METHODOLOGY FOR TOTAL REALIZED PAY IS TO INCLUDE ALL OF THE FOLLOWING (TYPICALLY FOR THE THREE-YEAR PERIOD):

| COMPENSATION ELEMENT | ISS APPROACH | CAP PERSPECTIVE |
|--|--|--|
| Base Salary | As reported for all three years | We support this approach |
| Bonus / Short-term Non-Equity Incentives | As reported for all three years | We support this approach as it reflects what was actually earned |
| Long-term Cash | The earned value of the award (if earned during the same measurement period) or its target value in the case of on-going award cycles (i.e., not completed before the end of the measurement period) | <ul style="list-style-type: none"> ISS' approach of using target for incomplete performance periods could overstate or understate, perhaps significantly, the amount that is ultimately delivered to the CEO as all this performance-based compensation is still 100% at risk. An alternative approach would be to use what actual payouts of these plans were during the three-year period, recognizing that the payouts may relate to performance before the three-year period under review This is further exacerbated where companies have these types of plans as the largest component of compensation |
| Share-based Awards | The value (based on stock price as of the end of the measurement period) of awards made during the period (less any shares/units forfeited due to failure to meet performance criteria based on complete and clear disclosure); or, if performance awards remain on-going, the target level of such awards | |

ISS METHODOLOGY FOR TOTAL REALIZED PAY IS TO INCLUDE ALL OF THE FOLLOWING (TYPICALLY FOR THE THREE-YEAR PERIOD):

| COMPENSATION ELEMENT | ISS APPROACH | CAP PERSPECTIVE |
|---|---|--|
| Stock Options | The net value realized with respect to such granted options which were also exercised during the period; for options granted but not exercised during the measurement period, ISS will re-calculate the option value, using the Black-Scholes option pricing model, as of the end of the measurement period | <ul style="list-style-type: none"> The use of the Black-Scholes value of stock options could be problematic, as underwater options have no intrinsic value and really do not have a “realizable” value unless the stock price appreciates. However, for what ISS is attempting to do with the realizable pay analysis (i.e., test the validity of the quantitative test and/or “demonstrate the company’s adherence to a pay-for performance philosophy”) we believe that using the Black-Scholes option pricing model is a plausible method for measuring potential pay |
| Change in Pension Value and Nonqualified Deferred Compensation Earnings | As reported for all years | <ul style="list-style-type: none"> Including the change in pension value introduces unnecessary “noise” to the calculation that has less to do with compensation design or performance than with interest rate fluctuations or the oddities of actuarial calculations We believe ISS should view the change in pension value on a qualitative basis to see if a company has poor practices related to pension (e.g., significantly higher formula for executives, grants of additional years of service, etc.) |

CAP Perspective *Almost any definition of realizable pay will be subject to criticism and scrutiny. Our main concern with the realizable pay approach proposed by ISS is that it is not directly connected to a review of the firm’s performance over the time period. Comparing realizable pay to grant date pay may be an indicator of the pay for performance relationship, but it is our position that it would be better viewed next to multiple years of performance relative to peers. We suspect that over time ISS will refine how realized pay is defined and could directly incorporate it into the pay-for-performance quantitative test.*

ISS notes that it is their intent to collect the required information in a standardized way that is easily obtained from a company’s tabular disclosure. Companies can help improve the accuracy of ISS’ analysis by clearly revealing, in a supplemental table, any performance based awards that have been forfeited prior to the completion of ISS’ assessment period (i.e., most recent three years).

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ISS QUICKSCORE

On January 25th, ISS rolled out QuickScore as a replacement of its GRId score. It will apply a scoring system based on the decile ranking of a company relative to others in the respective country.

- **Coverage:** 3,000 largest U.S. public companies
- **Methodology:** The scoring will be applied over the same four quadrants used for the GRId score, with several subcategories in each quadrant

CATEGORIES FOR THE QUICKSCORE

| BOARD STRUCTURE | COMPENSATION/REMUNERATION | SHAREHOLDER RIGHTS | AUDIT PRACTICES |
|---|--|---|--|
| <ul style="list-style-type: none">• Board Composition• Composition of Committees• Board Practices• Board Policies• Related Party Transactions | <ul style="list-style-type: none">• Pay for Performance• Non-Performance Based Pay• Use of Equity• Equity Risk Mitigation• Non-Executive Pay• Communications and Disclosure• Termination• Controversies | <ul style="list-style-type: none">• One Share One Vote• Takeover Defenses• Voting Issues• Voting Formalities• Other Shareholder Rights Issues | <ul style="list-style-type: none">• External Auditor• Audit and Accounting Controversies• Other Audit Issues |

- **Screening Process:** Assesses companies based on multiple qualitative factors to see if they exceed, meet, or fall short of market practices
 - › Quantitatively assessed correlation between 16 performance and risk factors
- **Factor Criteria:** Provides red flag summary of practices that raised concern and green stars for practices that mitigate concern
- **Data Verification:** Companies have the ability to verify their data between January 28th and February 15th. When the product launches, companies will once again be able to verify their data

CAP Perspective: *The structure and criteria of the QuickScore appear very similar to what was used under the GRId score. The main change appears to be the relative scoring approach, which should provide a better indicator of governance risk compared to other companies*

CONCLUSION

While ISS' evaluation criteria are always challenging for companies to address, the changes made to the ISS pay-for-performance evaluation and the transition from GRId to QuickScore represent directional improvement. We expect that the calculation of realizable pay and its role in the pay for performance evaluation will continue to evolve over time. Similar to GRId, it is not clear what role QuickScore will play in shareholder voting decisions. We expect that it will be a starting point for deeper analysis in cases where the score indicates governance concern.

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