

## Comments on ISS' Draft 2014 Proxy Voting Policies (U.S.)

■ By **Margaret Engel** and **Matt Vnuk**

Compensation Advisory Partners LLC ("CAP") submitted comments to ISS on their draft 2014 U.S. policy updates related to compensation.

Our comments are detailed below.

### MANAGEMENT SAY-ON-PAY PROPOSALS (U.S.)

ISS will recommend voting against advisory Say on Pay resolutions related to executive compensation if there is a perceived misalignment between CEO pay and company performance, based on both quantitative tests and a qualitative review of the pay program and related Compensation Committee decisions.

ISS is considering the following policy change for 2014:

Simplify the methodology for calculating the Relative Degree of Alignment (RDA) pay-for-performance screen. The proposed new methodology is to calculate the difference between the subject company's TSR rank and the CEO's total pay rank within a peer group, as measured over a three-year period (or for as many fiscal years that the company has been publicly traded and has disclosed pay data, if less than three years).

Currently the RDA screen is calculated as the difference between the company's TSR rank and the CEO's total pay rank within a peer group, as measured over one-year and three-year periods. The one-year and three-year periods are weighted 40% and 60%, respectively.

### ISS REQUEST FOR COMMENT – PROPOSED RDA POLICY CHANGE

*Are there circumstances under which performance or pay from the most recent year should weigh more heavily in a pay-for-performance analysis?*

**CAP Perspective:** We agree with ISS' preliminary decision to apply a longer-term focus to the quantitative RDA test; i.e., solely a three-year timeframe for both pay and performance. However, we believe that recent Committee decisions best relate to company performance over time. We urge ISS to state that the qualitative assessment will place particular emphasis on recent Committee decisions that apply prospectively in a year following:

- Below par shareholder support for an advisory Say on Pay resolution (less than 70%)
- A CEO transition
- A corporate transformation (merger, major acquisition, etc.)

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### ISS is considering the following policy change for 2014: Simplify the methodology for calculating the Relative Degree of Alignment (RDA) pay-for-performance screen.

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We also urge ISS to use realizable pay in the RDA test (with ISS' current definition and assumptions), instead of grant date pay. Realizable pay would better show if pay was aligned with performance over time. This methodology change could also apply to the PTA test.

Finally, we urge ISS to address the following questions and concerns in its 2014 policy release.

- Under the ISS 2014 policy, as proposed, a three-year point-to-point TSR will be used for the quantitative RDA test, which in practice reflects a compound annual growth rate. This approach could lead to volatile RDA results since it uses a single day as the starting point and ending point in the performance analysis. An alternative approach that ISS should consider is to calculate TSR using the average starting and ending stock prices over a 20-trading-day period. This will reduce volatility and add credibility to the results.
- ISS should also consider adopting an alternative approach for calculating TSR performance that reflects the average relative position of TSR during each of the three most recent one-year periods, rather than a compound annual growth rate. Looking at performance trends over multiple time periods may yield additional insight into performance and related pay decisions.
- Also under the ISS 2014 policy, as proposed, three-year average (arithmetic mean) compensation will be used in the RDA test. We support this approach, but certain issues should be acknowledged. This approach does not fully address the problematic timing of proxy reporting where a Compensation Committee evaluates performance in the year just ended and makes a long-term incentive award in the beginning of the following year. This award is reported in the proxy in the following year and does not impact ISS' analysis. We urge ISS to acknowledge that this timing (reporting) difference will be considered in its qualitative assessment of the pay program and related decision making. Given the imperfections in the compensation data analyzed, we support the simple, straightforward approach that is proposed for the compensation data included in the RDA quantitative test that focuses solely on a longer time horizon vs. the current approach. The approach, as proposed, will also smooth out some of the extremes seen in individual years.
- We ask ISS to provide its reasoning as to why it is appropriate to weigh recent pay and performance more in the PTA test, but not in the RDA test. Why does it make sense for these tests to incorporate inconsistent timeframes and weightings?

#### **ISS REQUEST FOR COMMENT - PROPOSED RDA POLICY CHANGE (CONT'D)**

*Are there any unintended consequences from using a simple, unweighted three-year pay and performance measure as the basis for the RDA screen?*

**CAP Perspective:** *We believe the proposed approach for performance measurement is potentially too volatile since it depends heavily on a single "start" point and a single "end" point.*

As stated above, we urge ISS to use an average stock price at the beginning and end points of the TSR calculations for its pay versus performance tests, which would align with methodology used in the ISS SVT tool. We believe that use of a 20-trading-day average stock price would limit the impact of very short-term stock price fluctuations on the results.

A second alternative, also noted above, would be to use the average relative position of TSR during each of the three most recent one-year periods, rather than a compound annual growth rate. This would be beneficial since it would reduce volatility in the TSR calculation.

#### **ISS REQUEST FOR COMMENT – OTHER**

*Please feel free to add any additional information or comments on the proposed policy change.*

**CAP Perspective:** *We have additional comments that relate to ISS Say on Pay vote recommendations. Outlined below, we describe additional changes that we urge ISS to consider.*

#### **RDA and PTA Tests – Time Period**

We urge ISS to provide its reasoning for why the timeframe used for the RDA quantitative test (three years) is different than the timeframe used for the PTA quantitative test (five years). Why is the use of inconsistent time frames appropriate?

#### **RDA Quantitative Thresholds**

ISS has indicated that the thresholds for the Medium and High level of quantitative concern have not yet been set by ISS Research for 2014 pay vs. performance analyses. We urge ISS to expand the thresholds for the RDA test so that fewer companies are flagged with "Medium" or "High" concern levels and, in turn, increase consistency between the RDA test and the PTA test.

In the December 20, 2011 ISS white paper titled “Evaluating Pay for Performance Alignment”, in the “Back-testing the Measures” section, a table was included:

MEASURE	LEVEL THAT MAY TRIGGER HIGH CONCERN IN CONJUNCTION WITH OTHER MEASURES (“MEDIUM” CONCERN)	LEVEL THAT TRIGGERS HIGH CONCERN BY ITSELF (“HIGH” CONCERN)
RDA	-30 (~25 <sup>th</sup> percentile)	-50 (~10 <sup>th</sup> percentile)
MOM	2.33x (~92 <sup>nd</sup> percentile)	3.33x (~97 <sup>th</sup> percentile)
PTA	-30% (~10 <sup>th</sup> percentile)	-45% (~5 <sup>th</sup> percentile)

As shown above, 1 in 4 companies is expected to receive “Medium” concern from the RDA test, but only 1 in 10 companies is expected to receive “Medium” concern from the PTA test.

- We believe the amount of companies expected to receive “Medium” and “High” concern within each of ISS’ quantitative screens should be more consistent
- We find the thresholds (~10<sup>th</sup> percentile and ~5<sup>th</sup> percentile) in the PTA test to be most reasonable to identify outliers, and believe expecting one in four companies to receive “Medium” concern from the RDA test is unreasonably high

#### Performance Goals – Evaluation of “Rigor”

ISS reviews the rigor of performance goals in its qualitative pay-for-performance assessment. We urge ISS to be more transparent regarding the parameters for this assessment.

#### Multi-year Long-term Grants

When recruiting new CEOs, companies often grant long-term incentives that are intended to make up for compensation forfeited from a previous employer (often called “make-whole” grants). In these instances, we urge ISS to exclude these grants from the pay-for-performance testing since the grants fill a very specific need and would not be granted in the absence of forfeited compensation.

#### Time-based Stock Options

In our experience, many investors and most corporate directors view time-based stock options as a performance-based long-term incentive vehicle; i.e., they disagree with ISS’ classification of this form of compensation as “non-performance-based pay”. We urge ISS to include questions on this topic in its next policy survey.



Please contact us at (212) 921-9350 if you have any questions about the issues discussed above or would like to discuss your own executive compensation issues. You can access our website at [www.capartners.com](http://www.capartners.com) for more information on executive compensation.