CAPflash
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ISS' New Quantitative and Qualitative Approach for Evaluating Pay for Performance Alignment

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On December 20th, Institutional Shareholder Services ("ISS") released its white paper on "Evaluating Pay-for-Performance Alignment: ISS' Quantitative and Qualitative Approach." In this white paper, ISS disclosed its 2012 policy on assessing a company's pay-for-performance relationship as well as its revised approach for selecting a peer group.

We have summarized the quantitative and qualitative pay-for-performance assessment and the peer group selection process including key findings and implications.

Iss' Quantitative Assessment Of Pay-For-Performance Alignment

Historically, ISS reviewed a company's one- and three-year total shareholder return ("TSR"). If TSR was below the median of the GICS industry group, ISS reviewed the CEO's year-over-year change in pay level plus the five year trend in CEO pay relative to TSR performance over the same period. ISS' current TSR screen only triggers a closer look for approximately 30% of companies.

For 2012, ISS developed a new pay-for-performance assessment that will focus on both relative and absolute company performance. The objective of ISS' new methodology is to achieve three goals:

1. Measure the pay-for-performance alignment over multiple time horizons since executive compensation and company performance span a time horizon longer than one year.

2. Use multiple measures to assess this alignment because a single measure cannot decisively indicate that pay and performance is aligned.

3. Provide shareholders with information on the strength of the pay-for-performance relationship.

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ISS' new pay-for-performance alignment is based on two relative measures (relative degree of alignment and multiple of median) and one absolute measure (pay – TSR alignment). ISS back-tested each of these measures for a sample of 2,500 companies over a 5 year period (2006 – 2010). Based on ISS' findings, they developed guidelines to identify outliers to denote companies that may have a misalignment between pay and performance.

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Relative Degree of Alignment ("RDA")

RDA measures a company's CEO pay level and TSR performance relative to its ISS peer group for both a one- and three-year period. ISS analyzes pay[1] levels disclosed for the CEO over the past three years and TSR based on the target company's fiscal year end. ISS determines the company's percentile rank for one- and three-year pay and performance. ISS calculates the RDA by subtracting the combined pay percentile ranks from the combined performance percentile ranks. The combined percentile ranks are weighted 40% for one-year and 60% for three-year (see below for an example of the calculation).

	Percentile Rank		RDA
	Performance	Pay	
1- Year (40% weight)	42	52	-10
3-Year (60% weight)	26	64	-38
Total	**32**	**59**	**-27**

A company's RDA can range from -100 to +100 with -100 reflecting high pay (100th percentile) and low performance (0th percentile). Based on ISS' back testing, 50% of companies had an RDA range of -28 to +30. In other words, from ISS' perspective, all things being equal, a zero RDA, would mean a company's pay is tightly aligned with performance and a high positive number would indicate the company's pay levels are conservative relative to the performance delivered.

Multiple of Median ("MOM")

MOM measures the magnitude of a CEO's pay for one-year relative to the median of the comparison group. Unlike RDA, the multiple of median for a company can be infinite. Based on ISS' back-testing, 75% of companies have a multiple of median of 1.5x median or less and 90% of companies pay less than 2.1x median.

Pay-TSR Alignment ("PTA")

PTA measures, directionally, how well pay increases for the CEO tracks with shareholder performance over a five-year period. ISS will use regression analysis to determine the trend in CEO pay and TSR over the five-year period. The final PTA will be the performance slope minus the pay slope. Based on ISS' back-testing, PTA ranges from -106% to +129% with a median value of -3% (i.e., the trend rate for CEO pay at the median company was 3 percentage points higher than performance).

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ISS Quantitative Assessment

ISS will analyze the findings from the RDA, MOM and PTA to determine if a company has a disconnect between pay and performance. A company that is a significant outlier (i.e., high concern) on any one measure or an outlier (i.e., medium concern) on multiple measures will receive a "high concern" level for a misalignment between pay and performance and ISS will conduct a qualitative assessment.

ISS developed parameters (see chart), based on its back-testing of each measure, to determine if a company elicits further review of its compensation practices. ISS will identify companies that are outliers (or significant outliers) for each measure.

1 ISS calculates pay based on the values disclosed in the Summary Compensation Table excluding the stock award and stock option award values. ISS revalues equity-based grants using its own standard set of assumptions.

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Measure	Medium Concern		High Concern	
Relative Degree of Alignment	-30	~ 25th Percentile	-50	~10th Percentile
Multiple of Median	2.33x	~ 92nd Percentile	3.33x	~ 97th Percentile
Pay-TSR Alignment	-30%	~10th Percentile	-45%	~5th Percentile

ISS compared results on its new quantitative assessment to the voting outcomes from say on pay resolutions. Companies with low concern on the pay-for-performance alignment received, on average, 92% support on the say on pay resolution while companies with a high level of concern received 81% support, on average.

CAP Perspective: *ISS' new quantitative analysis provides more rigor to identifying companies that may have a pay-for-performance issue. By placing more weight on pay and performance trends over a longer period of time, ISS is recognizing that one-year may not be a predictive indicator of the relationship between a CEO's pay and company's performance. However, by limiting the pay-for-performance assessment to TSR, ISS is not considering other financial factors that may ultimately determine compensation delivered/earned by executives. Additionally, by only analyzing the grant-date value of equity awards, ISS is not taking into account that outstanding equity awards may have little to no value despite the intended value at grant given many are performance contingent and tied to stock price.*

Companies that would have received a high level of concern under ISS' new pay-for-performance assessment still received approximately 80% of shareholder support on the say on pay resolution. However, shareholders may scrutinize a company's executive compensation program in light of a high concern assessment by ISS. We believe the new tests provide a more robust perspective on pay-for-performance; however, they do not in and of themselves take into account company specific factors that may be driving pay decisions. This is why telling a compelling story for why the Company and Compensation Committee made specific decisions, especially when there may be a pay-for-performance disconnect, is critical. These items will only be picked up through the qualitative assessment and given the challenges institutional investors and their advisors face in reviewing an extraordinary number of proxies in such a short period of time, the more clear and concise the rationale, the better.

Iss' Qualiitative Assessment Of Pay-For-Performance Alignment

Companies that receive a high concern level based on the quantitative review from ISS will receive an in-depth qualitative assessment to determine how different elements of compensation are used to facilitate or impede shareholder value creation. ISS' qualitative review may include an evaluation of:

Companies that receive a high concern level based on the quantitative review from ISS will receive an in-depth qualitative assessment to determine how different elements of compensation are used to facilitate or impede shareholder value creation.

- Performance-based compensation received by executives (focusing on recent decisions made by the Compensation Committee). This review will include the ratio of time-based vs. performance-based awards, cash awards paid vs. target opportunity level, the extent to which total compensation is comprised of performance-based awards, metric(s) used in performance-based awards and any adjustments made to non-GAAP metrics.

- Peer group used for benchmarking purposes as well as the company's compensation philosophy. ISS will examine if a majority of peer companies are larger in size than the target company or if the target company has an above median pay philosophy.

- Financial / operational results of the company if the cash payout is the main reason for the pay-for-performance misalignment. ISS will review the performance goals related to the cash payout and may examine absolute and relative performance for GAAP measures (including return and growth measures) to determine if the quantitative findings are inconsistent with the company's financial performance.

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- Special circumstances (such as a new CEO or biennial equity grants) that may distort the quantitative analysis. Such circumstances will not automatically nullify the quantitative assessment but may be included as part of its review.

CAP Perspective: *This qualitative assessment will compel companies to provide a clear rationale for their compensation decisions (including any recent compensation action) in the CD&A. This may also influence companies to include a concise executive summary of performance and pay at the beginning of the CD&A. We believe including the review of non-TSR metrics is an important step in understanding how decisions are made. Companies should consider how best to articulate their metrics so a reader of the CD&A can understand how decisions and outcomes occurred.*

Peer Group Selection Process

Current Approach

ISS' currently selects a peer group compromised of 8 - 12 companies in the same six-digit Global Industry Classification Standard ("GICS") code based on .5x – 2x the company's revenue size (or asset size for financial firms). If there are insufficient companies within the six-digit GICS, peer companies would be supplemented from the four-digit GICS or even the two-digit GICS, using the same size parameters. ISS currently uses market cap as another screen to find additional peers when companies have either very low or high revenue or asset size. For some very large companies, ISS may compile companies using a standard index (such as the Dow Jones 30 or the S&P 500 index).

Updated Peer Group Selection Process

ISS has revised its selection process for the upcoming 2012 proxy season. ISS will compare a company's pay-for-performance alignment to a group of 14 – 24 companies. A peer group will be based on a company's GICS code, revenue (or asset) size as well as market cap. ISS will create a peer group twice a year (based on quarterly data as of June 1 and December 1) for Russell 3000 companies based on the following:

- Revenue for the most recent trailing 4 quarters
- Total assets as of the most recent quarter
- 200 day average stock price x shares outstanding as of the most recent quarter (market cap)

To determine the peer group, ISS will identify companies in the two-digit GICS code with a revenue (or asset) size of .45x – 2.1x and a market cap of .2x – 5x. ISS has expanded the revenue/asset size from the standard .5x – 2x range to ensure that similar companies that are slightly beyond the standard range are included as potential peers. From this universe, ISS will select companies within the same six-digit GICS code while trying to maintain the target company's revenue/asset size around median. ISS may select up to 24 companies from the six-digit GICS code for a peer group however a minimum of 14 companies will consider the peer group complete. If 14 companies are not selected, ISS will expand the list of potential peers to the four-digit GICS code and if the peer group list still does not contain 14 companies, the two-digit GICS code. On an exceptional basis, ISS may exclude company (for example, if a comparator is in bankruptcy).

ISS has also developed two supplemental methodologies if a peer group yields less than 14 companies under their new method.

1. ISS has identified approximately 25 very large non-financial companies in the Russell 3000 (revenue of $50B and a market cap greater than $30B) with very few to no peers. For ISS' pay-for-performance evaluation, these companies will be compared to each other. ISS notes that industry-specific performance will be considered if a qualitative review is conducted.
2. If a 14 company peer group cannot be yielded under the standard methodology, ISS will include com-

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panies with revenues beyond the initial revenue range of .45x – 2.1x while maintaining the target company's revenue around median and maintaining the market cap range.

CAP Perspective: *ISS has provided more controls in selecting companies within a similar size range. Although ISS will review companies in a specific GICS code, there are some limitations to relying solely on the GICS code. Companies within the same GICS code may not be business competitors and, in some instances, a direct competitor may be within a different two-digit GICS code. ISS will not provide a qualitative review of selected peer companies and a peer group may, therefore, contain companies that do not compete with the target company. Additionally, companies with direct competitors that compete for talent and business but may be somewhat larger or smaller than the target company will most likely not be considered due to the size constraints. Therefore, while this new methodology may bring ISS peers more in line with peer groups used internally by companies, significant differences may continue to exist.*

Conclusion

ISS' new peer group selection process and pay-for-performance assessment are more transparent and more rigorous than the current approach. Although ISS has changed its peer group selection process, we expect that there may still be some disagreement on the business relevance of companies in ISS' peer group especially when the selection parameters are expanded to include companies in the two- and four-digit GICS codes. The quantitative assessment is a more robust analysis of a company's pay-for-performance alignment with more consideration for longer term performance than the current approach. Companies will want to assess their pay-for-performance from various perspectives including those similar to ISS to understand potential shareholder reaction.

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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 for more information on executive compensation.