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EXEQUITY

Independent Board and Management Advisors

Client Alert

ISS Releases Technical Document With Pay-for-Performance Methodology for 2012

On December 19, 2011, Institutional Shareholder Services Inc. (ISS) issued its technical document that details its pay-for-performance (P4P) methodology for 2012.[1] The technical document lays out ISS's quantitative and qualitative assessment methodologies under its P4P policy for 2012. Key details of the methodology are summarized below.

Pay

ISS continues to define pay for purposes of its P4P policy as total compensation as reflected in the Summary Compensation Table. Thus, the definition of pay still mixes and matches pay elements—using some amounts actually realized during the year (base salary, bonus, and non-equity plan compensation) and other prospective opportunities that require ISS to calculate grant date values (restricted stock, performance shares, stock options, and stock appreciation rights (SARs)).

ISS also continues to conduct its own valuation of stock options and SARs. ISS's valuation methodology generally results in values significantly higher than those used for financial reporting and proxy disclosure purposes. This valuation methodology uses the full term of these instruments, a presumed constant dividend yield (derived from historic dividend yield percentages), the historic three-year volatility, and a risk-free rate derived from U.S. government instruments.

Exequity Comment: *ISS justifies its methodology by stating that it should use the numbers disclosed in the Summary Compensation Table. However, it is unwilling to accept the values companies report for their stock options and SARs in that table and for financial reporting purposes (which amounts are subject to review by both the company's auditors and the Securities and Exchange Commission), and instead conducts its own valuation. This has caused (and will continue to cause) companies a number of headaches, including not anticipating the amount of CEO total compensation that ISS will determine.*

Performance

For purposes of its P4P policy, ISS defines performance as total shareholder return (TSR) over 1-, 3-, and 5-year periods. ISS indicates that it does not advocate companies use TSR as the metric underlying their incentive plans, and that shareholders may prefer that incentive awards be tied to a company's short- and long-term business goals. ISS justifies this reliance on TSR by stating that if a company's business strategy is sound and well executed, it is expected to create value for shareholders over time, as reflected in long-term shareholder returns.

[1] The ISS technical document on P4P, *Evaluating Pay for Performance Alignment, ISS' Quantitative and Qualitative Approach* is available at http://www.issgovernance.com/sites/default/files/EvaluatingPayForPerformance_20111219.pdf.

Exequity Comment: *It is interesting that ISS is justifying the use of TSR by reference to long-term performance, when, in fact, ISS continues to weight short-term performance (less than five years) much more heavily in its analysis of pay and performance for purposes of the P4P policy. Its rationale is that the say-on-pay (SOP) resolution is typically directed at the prior year's compensation, and special attention should be paid to recent experience.*

It also is interesting that while ISS points to TSR as the best indicator of a company's performance over time, it continues to characterize stock options as not being "performance-based" compensation.

Relative and Absolute Alignment Over Time

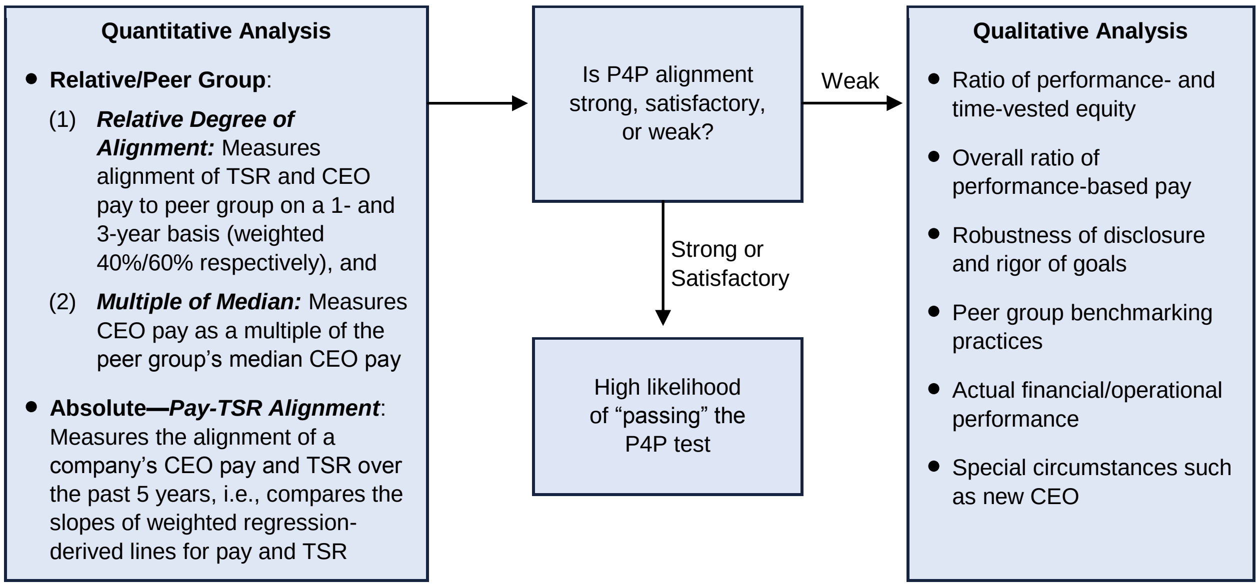
ISS cites its 2011 policy survey[2] as support for its position that two important factors in determining P4P alignment are pay relative to peers (which 62% of institutional survey respondents said was very relevant) and pay increases that are disproportionate to the company's performance (which 88% of institutional survey participants said was very relevant). Consequently, ISS incorporated both of these views into its ***quantitative*** analysis under the P4P policy. In cases where ISS's quantitative analysis indicates a significant P4P misalignment, ISS will conduct a more in-depth ***qualitative*** analysis to determine either the probable cause or any mitigating factors.

Exequity Comment*: In this revised P4P methodology for 2012, ISS eliminates the bright-line test that companies could review to determine whether they might have an issue with the P4P policy, i.e., the review of a company's 1- and 3-year TSR against the median TSRs of its 4-digit GICS group (Old TSR Test). Under the Old TSR Test, if a company's 1- and 3-year TSRs were both above the 4-digit GICS group's median TSRs, ISS generally would not find a P4P disconnect to exist. Thus, companies were able to determine rather quickly and easily whether they would be subject to increased scrutiny under the ISS P4P policy. For 2012, companies will no longer be able to quickly and easily determine whether they will be subject to increased scrutiny under the ISS P4P policy due to the much more complicated methodology ISS is employing for 2012.*

How the P4P Policy Will Be Applied

The chart on the following page shows the flow of how ISS will apply its P4P policy in 2012. Keep in mind that there is never an ***automatic*** "failure" under the P4P policy, because ISS applies its P4P policy on a case-by-case basis, and some subjectivity is to be expected in its application, especially if a company ends up being subject to a more in-depth qualitative analysis.

[2] *2011-2012 Policy Survey Summary of Results*, September 2011, available at http://www.issgovernance.com/files/PolicySurveyResults2011.pdf



Exequity Comment: *Regardless of the results of the quantitative analysis, ISS reserves the right to recommend against SOP proposals and/or the election of directors who sit on the compensation committee if there are any unusual or extraordinary practices that nevertheless raise significant concerns about a company's P4P alignment. However, situations in which companies with strong or satisfactory P4P alignment under the quantitative analysis receive such negative vote recommendations are expected to be quite rare.*

P4P: Quantitative Analysis

ISS settled on three new measures to utilize in its quantitative analysis under the P4P policy:

- **Relative Degree of Alignment (RDA)**—Compares the percentile ranks of a company's CEO pay and TSR performance, relative to an industry- and size-derived ISS peer group, over 1- and 3-year periods. To determine RDA, ISS subtracts the pay percentile from the performance percentile for both the 1- and 3-year data sets. ISS then combines the differences found on a weighted basis, 1-year difference weighted at 40% and 3-year difference weighted at 60%. RDA values will range from -100 to +100, with -100 representing high pay for low performance (i.e., 100th percentile pay combined with 0th percentile TSR performance), zero representing a high degree of alignment (pay rank and performance rank are equal), and positive values representing high performance for low pay.

  Exequity Comment: *Exequity has confirmed with ISS that there likely will be a disconnect between the time periods used for the RDA analysis. TSRs for the subject company and all its peers are measured (backwards) from the last day of the month closest to the subject company's fiscal year-end date. Compensation figures for all companies are as of the last available disclosed information. So, if a calendar-year company has a meeting date early in the proxy season, before ISS has a chance to capture all the 2011 compensation data of its peers in its ExeComp Analytics (ECA) database, then it is quite likely the company's RDA analysis will look at TSRs ending December 31, 2011 and compensation data from 2011 for the subject company and from 2010 for the ISS-selected P4P peers (assuming they are also calendar year companies). This will cause a disconnect between the TSR data and the compensation data of the ISS-selected P4P peer companies as well as a disconnect between the subject company and its ISS-selected P4P peer companies. ISS has indicated that it expects compensation data from newly-filed proxies to generally be available in its ECA database within two to five business days after filing (we will have to see how well ISS can deliver on this commitment).*

- **Multiple of Median (MOM)**—Expresses the prior year's CEO pay as a multiple of the median pay of its peer group for the same period. MOM is calculated by dividing the subject company's CEO pay by the median pay for the peer group.

  Exequity Comment: *As noted above, there likely will be a disconnect in the pay data used for the peer companies and the subject company. Consequently, it is likely that the MOM analysis will also suffer from this disconnect, i.e., subject company's 2011 CEO compensation would be compared to the ISS P4P peer company CEO median 2010 compensation, which is likely to cause issues for some companies.*

- **Pay-TSR Alignment (PTA)**—Absolute measure that compares the trends of the CEO's annual pay and the value of an investment in the company over the prior 5-year period. This is similar to what ISS has been doing for the past two years as embedded in a chart included in its Proxy Reports. However, the new PTA methodology makes this much more of a quantitative exercise as it claims to effectively look at the slopes of weighted linear regressions for pay and for indexed TSR over the past five years. The PTA score is calculated as the TSR Trend minus the Pay Trend. Thus, if the slope of the Pay Trend line is steeper than the slope of the TSR Trend line, the PTA score will be negative.

  Exequity Comment: *In the PTA analysis, the slope of the pay line could have some interesting results for companies—but not in the good way. The less volatility the pay line has the less likely it will be that there will be an issue with PTA. However, even if pay and TSR performance appear to be moving directionally in a similar manner, the magnitude of the changes in each may be disproportionate, which could cause the PTA score to be lower than one might otherwise expect.*

Peer Groups

Given the above relative components of the ISS P4P analysis (RDA and MOM), there is an increased premium on how ISS constructs companies' peer groups. ISS indicates that peer groups for most companies will be determined using the company's GICS classification, identifying companies that have between **0.45x** and **2.1x** the **company's annual revenues** (assets for financial institutions), and **market capitalizations** of between **0.2x** and **5x** the company's. ISS starts looking for matching peers in a company's 6-digit GICS industry. If not enough qualifying peers are identified, ISS will then broaden its search to the 4-digit GICS group and then the 2-digit GICS sector (first selecting companies closest in size and, where possible, alternating between companies larger and smaller than the subject company). The peer group may range from a minimum of 14 companies to a maximum of 24 companies. ISS intends that the subject company be right around the median size of the peer group so selected, i.e., in terms of revenues.

For companies for which this methodology does not yield 14 peer companies, ISS will take the following actions, depending on the category the subject company falls into:

- If the company is a **"super-mega" non-financial company**, i.e., over $50 billion in revenue and at least $30 billion market capitalization (which ISS believes to cover about 25 companies in the Russell 3000 Index, roughly equivalent to the Dow 30 companies), the company will be compared to this special peer group of "super-mega" companies.

- If a company is **not** a super-mega company but ISS is having trouble coming up with 14 peers, ISS will relax the revenue (but not the market capitalization) parameters in its peer group selection process, while retaining the peers identified under the basic methodology, and add additional peers that are both larger and smaller to maintain the subject company as close as possible to the median of revenues for the peer group.

Triggers for Qualitative Analysis

ISS included a chart that indicated the scores under the three quantitative measures that could either alone or in combination with other factors cause ISS to conduct a more in-depth qualitative analysis of a company's P4P alignment.

Measure	"Medium" Concerns: Level That May Trigger High Concern in Conjunction With Other Measures		"High" Concerns: 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

Even a **single** measure rising to the level of **high concern** will trigger a more **in-depth ISS qualitative analysis**. ISS has indicated that one single measure rising to the level of medium concern will not necessarily trigger a more in-depth ISS quantitative analysis unless in conjunction with one or both of the other measures. ISS has calibrated the levels of concern for each measure based on empirical distribution and the strength of their relationship with voting results (both of which ISS determined by back-testing the measures). ISS indicates that "[t]his effectively "weights" the strongest measure (RDA) somewhat more heavily in the overall evaluation, since outlier status with respect to RDA begins at the 25th percentile (compared, for example, to outlier status with respect to PTA, which is triggered at the 10th percentile)."

Exequity Comment: *While the ISS methodology on the medium concern is not entirely clear yet, it could be that it is similar to the way that ISS approaches major and minor problematic pay practices—even one major problematic practice is enough on its own to trigger application of the problematic pay practices policy whereas a single minor problematic pay practice, without additional negative facts, would typically not trigger the problematic pay practices policy.*

P4P: Qualitative Analysis

If after conducting a quantitative analysis under the P4P policy ISS concludes that there is "weak" P4P alignment, i.e., that a high level concern exists with respect to the company's P4P alignment, ISS will conduct a more in-depth qualitative analysis of the company's pay programs to determine either the likely cause of the misalignment or mitigating factors. ISS has indicated that this analysis may include consideration of some or all of the following:

- **Strength of Performance-Based Compensation**—ISS will review the ratio of performance- to time-based equity awards as well as the overall ratio of performance-based compensation to total compensation, focusing on the compensation committee's most recent decisions. ISS expects companies that exhibit significant misalignment of pay and performance over time to strongly emphasize performance-based compensation (though not through a simple increase of the size of the pay package to make it performance-based). ISS will review recent cash payments and long-term incentive opportunities granted to evaluate their performance conditions. Awards that have only time-based vesting (e.g., most stock options and restricted share awards) are not considered strongly performance-based by ISS for this analysis.

ISS expects companies to fully disclose performance metrics and goals. ISS indicates that use of a single performance metric or similar metrics in both short- and long-term incentive plans may suggest inappropriate focus on one aspect of business results at the expense of others. Finally, if a company uses non-GAAP metrics, adjustments should be clearly disclosed along with rationale for such adjustment(s).

- **Peer Group Benchmarking Practices**—ISS will determine whether it believes a company has "cherry-picked" its peer group, i.e., by including a large number of peers that are larger than the subject company, or is targeting compensation at above the median of its self-selected peers.
- **Results of Financial/Operational Metrics**—If the disconnect is driven by cash pay, ISS considers the rigor of performance goals (if any) that generated cash payouts. ISS may also examine recent GAAP metrics (such as return measures and growth in revenue, profit, cash flow, etc.) for the subject company and in relation to its ISS peers.
- **Special Circumstances**—ISS will consider exceptional situations, such as recruitment of a new CEO in the prior fiscal year or unusual equity grant procedures (e.g., bi- or triennial equity grants) that may distort its quantitative analysis. But, such circumstances will not automatically negate other aspects of the analysis.

Exequity Comment: *If a company anticipates that it will draw a "high" concern level under the quantitative assessment portion of the ISS P4P policy and that a more in-depth qualitative assessment is likely to be conducted, it may find some benefit in ensuring that its proxy addresses P4P in a way that makes it easy for shareholders and ISS to understand how the company has taken steps to align its pay with its performance, paying particular attention to the factors mentioned above that could be considered as part of the ISS qualitative analysis.*

Conclusion

Under ISS's new P4P methodology, it will be much more difficult in 2012 to determine whether a company potentially will run afoul of the P4P policy and, as a result, might be at risk of receiving a negative ISS vote recommendation on its Management SOP proposal or against the members of its compensation committee. Companies should find it possible to estimate the peer companies that ISS will utilize in its P4P analysis,[3] and, thereby gain some understanding of how the company might fare under the quantitative analysis portion of the P4P methodology. Exequity has already conducted such analyses for a large number of companies.

Of course, no one (including ISS Corporate Services) can accurately predict what ISS Research will ultimately conclude in its own analysis, but companies now have more information to better assess whether they might be at risk of having ISS find that they have a significant P4P disconnect that warrants negative vote recommendations on their SOP proposals and compensation committee members.

[3] Exequity generally has been able to replicate potential peer companies utilizing the ISS P4P peer group methodology. However, it is not possible to completely ensure that any potential peer companies developed will match those actually used by ISS Research because the universe of potential peer companies is not fully known. ISS has indicated that potential peers include Russell 3000 Index companies along with the peers of such companies, but has not announced a full, detailed list of such companies.

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