Pay Governance
Advisory Services to Compensation Committees

Viewpoint on Executive Compensation

ISS Exploring Improvements to their Pay for Performance Methodology

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Each year, Institutional Shareholder Services (ISS) reaches out to various constituencies to enhance and update its Say on Pay (SOP) voting processes and policies. This year, ISS added a discussion forum with executive compensation consultants including Pay Governance LLC.

The meeting was hosted this week by Carol Bowie, ISS Head of Americas Research and Pat McGurn, ISS Special Counsel. The meeting covered a broad range of topics and demonstrated ISS's willingness to improve their SOP advisory services. **However, it was made clear that ISS was only gathering information and ideas that may or may not result in any changes to their current policy.** Pay Governance believes it is important for our clients to be aware of this evolving process.

The participants initially were asked their views on the most important issues with ISS's current pay for performance methodology. Common responses included:

- Peer group selection
  - Current process involving screens based on Global Industry Classification Standard (GICS) has produced many cases of peer groups with companies that are in substantially different industries than those of the target company
- Realizable pay versus grant date value
  - Use of grant date value of compensation as reported in the proxy can lead to inflated pay figures during periods of sustained stock price declines, especially with respect to stock options
- Understanding what investors really want
  - Is ISS policy determined by internal discussions and philosophies rather than investor feedback on what is important to them?

- Timing of LTI grants versus TSR measurement period
    - Companies typically make grants in Q1 of each fiscal year while ISS measures performance based on fiscal year-end stock price, creating a disconnect between when pay decisions are made and performance is measured
- Timing of when ISS policy is released
    - ISS's new guidelines are typically published in December to cover the current fiscal year when companies have very little time left to evaluate the impact of the new policy on their pay programs

The ISS team emphasized that they use the pay for performance quantitative test ONLY as an initial screen. The qualitative analysis is the primary factor in their determination of what their vote recommendation will be for the SOP proposal. They shared data that reinforce their statement. Based on their findings, almost half of companies (approximately 44%) who initially received a "High" concern on the quantitative test still received a "For" vote recommendation for their SOP proposal. ISS believes companies are putting too much emphasis on the quantitative aspect of the process.

The bulk of the meeting was spent on reviewing realizable pay and peer group selection.

1. **Realizable Pay**: ISS is considering using a type of realizable pay as another factor in their SOP vote recommendation, possibly in their qualitative review. They were exploring different ways in how to do a study (including how to value options, what time period should be used, how are in-cycle performance plans valued, etc.). They are open to suggestions on how to calculate this (for reference, see our Viewpoint article on realizable pay – "*CEOs Are Paid for Performance: Using Realizable Pay to Demonstrate Alignment with Total Shareholder Returns*").

2. **Peer Groups**: ISS acknowledges there is difficulty in constructing peer groups based on their current GICS screening method although they did mention that 80% of the time their ISS-constructed peer groups had at least 50% overlap with a company's proxy-disclosed peer group. They are considering adding a company's disclosed peer group in addition to the ISS-constructed peer groups to the quantitative pay for performance tests. They are clearly interested in this issue.

ISS certainly seemed open to some new methodologies that would reduce their "false negatives" (where ISS recommends "Against" a company that has aligned pay for performance; see Viewpoint article - "*Evaluating the ISS Test of CEO Pay for Performance for Say on Pay Votes: A Comparison of Pay Opportunity and Realizable Pay*" for more detail). It was a very productive work session and we believe ISS will seriously consider adopting some of these changes as part of their evaluation process going forward. Whether that's for 2013 or later is a bit of an unknown, but at least they are under discussion.

For further insights on ISS, see Viewpoint article "*Say on Pay Soul Searching at Proxy Advisory Firms*" and *"Better Second time Around: How Say on Pay 'Losers' Became 'Winners' in 2012"* [forthcoming].

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