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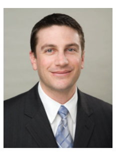
ISS Offers Guidance on Its Updated Pay-for-Performance Methodology




PAUL HASTINGS

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Institutional Shareholder Services (ISS), one of the largest proxy advisory firms, recently issued a "white paper"[1] outlining how ISS will implement the pay-for-performance proxy voting guidelines announced in its recent U.S. Corporate Governance Policy 2012 Updates (Policy Updates).[2] The white paper provides companies with a limited opportunity to determine how they are likely to perform against some of ISS' pay-for-performance criteria in advance of their 2012 annual meetings. The white paper also provides greater visibility into ISS' methodology for assessing pay-for-performance, which often has been criticized for its lack of transparency.

ISS' Prior Methodology; 2011 Say-on-Pay Results

The Dodd-Frank Wall Street Reform and Consumer Protection Act required most companies to propose an advisory shareholder vote on executive compensation ("say-on-pay") at annual stockholder meetings held in 2011. For the 2011 proxy season, ISS generally recommended that shareholders vote against the compensation of a company's executives if (1) the company's one - and three-year total shareholder return (TSR) fell below the median TSR of peers in its four-digit Global Industry Classification Standard (GICS) group,[3] and (2) the pay of the company's CEO was not aligned with the company's performance over this period (with heavier emphasis on the one-year analysis). Through September 1, 2011, ISS recommended that shareholders vote "against" approximately 12 percent of say-on-pay proposals at Russell 3000 companies.[4] At annual meetings reported in Securities and Exchange Commission (SEC) filings through the end of October 2011, 38 Russell 3000 companies failed to receive majority shareholder approval for say-on-pay and an additional 157 failed to receive at least 70 percent shareholder approval.[5]

ISS' 2012 Pay-for-Performance Methodology

The Policy Updates provide that for meetings held on or after February 1, 2012, ISS will continue its historical practice of conducting a quantitative and a qualitative assessment to determine whether CEO compensation is aligned with company performance. However, ISS has refined its methodology in an effort to reflect recent institutional shareholder feedback suggesting that ISS consider compensation practices over multiple periods using a series of distinct metrics, with more emphasis on the long-term context.[6] Based on its new methodology, if ISS determines that there is a significant misalignment between CEO pay and company performance over time, referred to as a "pay-for-performance disconnect," it generally will recommend that shareholders vote "against" the company's say-on-pay proposal in 2012.[7]

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– Quantitative Analysis

Under the new guidelines set forth in the white paper, for companies in the Russell 3000 index, ISS first will perform a quantitative assessment based on the following three factors: relative alignment of CEO pay and TSR, relative CEO pay compared to peer group, and absolute alignment of CEO pay and TSR. A "high" concern for any of the three individual quantitative factors will result in an overall "high" concern level for the quantitative component of the pay-for-performance evaluation. Multiple "medium" concern levels also may result in an overall "high" concern level. Companies that receive an overall "high" concern level further will undergo a qualitative assessment by ISS.

– *Relative Alignment of CEO Pay and TSR*

This measure, which is the most heavily weighted among the quantitative tests, compares the percentile ranks of a company's CEO pay and TSR performance, relative to an industry-and-size derived comparison group of 14-24 companies, over one - and three-year periods. As discussed in detail below, ISS selects the comparison group on the basis of industry (using GICS), revenue (or assets, for financial companies), and market capitalization. For CEO pay, ISS will continue to use total CEO compensation, as disclosed in the company's proxy statement summary compensation table. However, ISS also will apply an undisclosed set of assumptions to value a CEO's equity-based awards, rather than use the value calculated pursuant to SEC disclosure requirements.

ISS will calculate the relative degree of alignment as equal to the combined percentile rank of a company's TSR minus the combined percentile rank of the company's CEO pay within the ISS-selected peer group. Combined percentile ranks for CEO pay and for TSR performance are weighted averages of the one - and three-year comparisons, with a 40 percent weighting for the one-year comparison and a 60 percent weighting for the three-year comparison.[8]

The possible values for the relative degree of alignment will range from - 100 to +100, with positive numbers representing low pay for high performance and negative numbers representing high pay for low performance. ISS indicated that a score of - 30 (the 25th percentile) triggers a "medium" concern, and a score of - 50 (the 10th percentile) triggers a "high" concern.

– *Relative CEO Pay Compared to Peer Group*

This measure compares the compensation of the company's CEO to the compensation of CEOs in the company's comparison group. To calculate this measure, the company's one-year CEO pay is divided by the median one-year CEO pay for the comparison group. ISS indicated that a score of 2.33 (the 92nd percentile) triggers a "medium" concern, and a score of 3.33 (the 97th percentile) triggers a "high" concern.

– *Absolute Alignment of CEO Pay and TSR*

This measure compares the trends of the CEO's annual pay and the value of an investment in the company over the prior five-year period using the straight-line slopes of five-year trend lines (based on a linear regression) for CEO pay and TSR. The regressions are weighted to place slightly more emphasis on the most recent years. ISS indicated that a score of - 30 percent (the 10th percentile) triggers a "medium" concern and a score of - 45 percent (the 5th percentile) triggers a "high" concern.

– Qualitative Analysis

In the event the quantitative factors trigger an overall "high" concern level, ISS will perform a qualitative assessment designed to uncover mitigating factors or potential causes of the apparent misalignment between CEO pay and company performance. As part of the qualitative review, ISS may consider any one or more of the following four factors: strength of performance-based compensation, peer group benchmarking practices, results of financial/operational metrics, and special circumstances.

– *Strength of Performance-Based Compensation*

To determine the strength of a company's performance-based compensation, ISS will conduct a review of the ratio of performance - to time-based equity awards, as well as a comparison of the overall ratio of performance-based to total compensation. ISS will focus primarily on the compensation committee's most recent decision-making with respect to executive compensation and expects companies that historically have shown a significant misalignment of pay and performance will strongly emphasize performance-based compensation going forward. ISS also will consider a company's performance metrics and goals, which ISS believes should be disclosed fully and be reasonably challenging in the context of the company's past performance and goals.

– *Peer Group Benchmarking Practices*

If ISS concludes that there is a long-term disconnect between pay and performance, it next will review the company's disclosed benchmarking approach (if any) to determine whether benchmarking may be a contributing factor. ISS noted that selecting peers that are larger than the subject company, along with above-median compensation targets, may drive up CEO compensation irrespective of the company's performance. ISS expects companies to make detailed proxy statement disclosures regarding their self-selected peers, including the names of the peer companies and the process used to select them.

– ***Results of Financial/Operational Metrics***

If a disconnect is driven by cash pay, ISS will evaluate the rigor of performance goals (if any) that generated the cash payouts, and also may examine recent U.S. generally accepted accounting principle results on certain metrics, such as return measures and growth in revenue, profit and cash flow. Similar to benchmarking practices, ISS expects companies to make detailed disclosures regarding metrics, goals, and adjustments to results.

– ***Special Circumstances***

ISS also will consider exceptional situations, such as recruitment of a new CEO in the prior fiscal year or unusual equity grant practices (e.g., biennial or triennial awards) that may distort a quantitative analysis. Due to the longer-term emphasis of ISS' new methodology, however, ISS will no longer consider a company with a new CEO (i.e., one who has served for less than two consecutive fiscal years) to be exempt from the pay-for-performance analysis, except in extenuating circumstances.

– **Selection of Peer Companies**

ISS' quantitative review is dependent on its selection of 14 to 24 peer companies against which it compares the subject company's TSR performance and CEO pay over one - and three-year periods. These periods are measured from the last day of the month closest to the subject company's fiscal-year end. To determine the list of peer companies, ISS first chooses companies in the same two-digit GICS category with annual revenue (or assets, for financial companies) of between 0.45 and 2.1 times the subject company's annual revenue (or assets), and with market capitalizations of between 0.2 and 5 times the subject company's market capitalization. Peer groups are compiled twice per year using measurement dates of June 1st and December 1st. Revenue is calculated as the sum of the revenue for the most recent four quarters ending prior to the applicable measurement date. Total assets are calculated as of the end of the most recent quarter prior to the applicable measurement date. Market capitalization is calculated as the 200-day average trailing price multiplied by the shares outstanding as of the applicable measurement date.

From this list of companies, ISS selects those in the subject company's six-digit GICS category, first selecting the companies closest in size, alternating between those larger and smaller than the subject company where possible so as to maintain the subject company at or near the median of the comparison group. If the comparison group reaches the minimum 14 members, it is considered complete, provided that ISS may select up to a total of 24 comparison companies from the six-digit GICS category. If 14 comparison group members are not selected from this list, ISS repeats this process with companies that share the company's four-digit GICS category (and then two-digit GICS category, if needed) until 14 comparison companies are selected.

"Super-mega" non-financial companies, which are those with over $50 billion in revenue and at least $30 billion in market capitalization, will comprise a special peer group and therefore will be compared to one another for the quantitative pay-for-performance evaluation.

Advice for Issuers

With the white paper, companies now can evaluate the absolute alignment of their CEO compensation and TSR. However, without knowing their current peer group, companies are unable to calculate their relative performance at this time. In the meantime, those who wish to prepare a mock evaluation of their relative performance should consider using the peer group ISS used in the past when evaluating compensation practices for prior annual meetings.

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[1] Gary Hewitt & Carol Bowie, *Evaluating Pay for Performance Alignment: ISS' Quantitative and Qualitative Approach*, Institutional Shareholder Services Inc. (Dec. 20, 2011), available at http://www.issgovernance.com/sites/default/files/EvaluatingPayForPerformance_20111219.pdf.

[2] *U.S. Corporate Governance Policy: 2012 Updates*, Institutional Shareholder Services Inc. (Nov. 17, 2011), available at http://www.issgovernance.com/files/ISS_2012US_Updates20111117.pdf.

[3] GICS categorizes companies based on two-digit "sector" codes, four-digit "industry group" codes within those sectors, six-digit "industry" codes, and eight-digit "sub-industry" codes.

[4] Ted Allen et al., *2011 U.S. Postseason Report*, Institutional Shareholder Services Inc., 5 (updated Sept. 29, 2011), available at http://www.issgovernance.com/docs/2011USPostseason (percentage excludes S&P 500 issuers; ISS recommended that shareholders vote "against" approximately 15 percent of say-on-pay proposals at S&P 500 companies through September 1, 2011).

[5] Greg Ruel, *GMI's Say on Pay Review: Potential Say on Pay Failures for 2012*, GovernanceMetrics International, Inc., 1 (Nov. 2011), available at http://www2.gmiratings.com/news_docs/1772gmi_sayonpayreview_112011.pdf. Beginning in 2012, ISS is recommending "case-by-case" voting on compensation committee members (or, in exceptional cases, the full board) and on the company's current say-on-pay proposal when the prior year's say-on-pay proposal received the support of less than 70 percent of votes cast. (ISS calculates shareholder approval based on the number of votes cast). *U.S. Corporate Governance Policy: 2012 Updates*, *supra* note 2.

[6] *U.S. Corporate Governance Policy: 2012 Updates*, *supra* note 2, at 10.

[7] If ISS finds a pay-for-performance disconnect and the company does not present a say-on-pay proposal at the 2012 meeting, ISS will recommend that shareholders vote "against" the election of directors serving on the company's compensation committee. *U.S. Corporate Governance Policy: 2012 Updates*, *supra* note 2, at 8.

[8] If three years of data are not available, the combined measure will reflect only the one-year comparison.