

# Meridian Client Update

## Institutional Shareholder Services Releases Technical Documents on Governance Risk Indicators and Evaluating Pay for Performance Alignment

On December 19, 2011, Institutional Shareholder Services (ISS) released technical documents on its Governance Risk Indicators (GRId) scoring tool and on its new methodology for evaluating CEO pay for performance alignment. Newly released GRId 2.0 is an updated version of the initial GRId tool. GRId 2.0 will be launched in February 2012 for U.S. companies. Similarly, ISS' new methodology for evaluating CEO pay for performance will be applicable to public companies that hold shareholder meetings occurring on or after February 1, 2012. Highlights of these technical documents are discussed below.

### Governance Risk Indicators (GRId) 2.0

First introduced in 2010, GRId is a tool used by ISS for scoring public companies' corporate governance practices. GRId replaced the Corporate Governance Quotient, ISS' previous governance scoring tool. GRId generates absolute, non-numerical scores for a subject company across four governance categories: **Compensation, Audit, Board and Shareholder Rights**. These non-numerical scores are expressed in one of three concern levels: low, medium or high. A "high concern" level suggests a company's governance practices raise questions about long-term risk to investors.

Under GRId, ISS examines a total of 63 questions that are allocated among the four governance categories. Generally, the answer to each question is scored on a 10-point scale ranging from -5 to 5, with 0 representing a neutral score. A neutral score suggests that a company meets, though not necessarily exceeds, local governance standards. A positive score suggests a company exceeds local best practice. A negative score suggests concerns are evidenced. A key consideration of GRId is the level of disclosure made by a subject company. A negative score will often apply when a company has made no public disclosure with respect to a given question. The scoring for each governance category is aggregated to generate a "concern level."

Prior to GRId 2.0, the Compensation category covered 28 questions for U.S. companies. GRId 2.0 increased to 41 the number of questions in the Compensation category. GRId 2.0 also modified 7 legacy questions, left unchanged 16 legacy questions and eliminated 5 legacy questions. Some of the new questions incorporate ISS' modified CEO pay for performance methodology. ISS also created new subcategories related to compensation in order to better reflect the framework of ISS' principles for evaluating say on pay proposals. The following are the new subcategories under the compensation category: pay for performance, non-performance based pay, the use of equity, equity risk mitigation, communication and disclosure and termination/severance.

Although GRId 2.0 modifies GRId's internal rating and scoring methodology, it retains the same scoring approach at the category level (i.e., low, medium and high concern ratings).

## ISS' Evaluation of Pay for Performance Alignment

Beginning in 2012, ISS is implementing a **new methodology** to evaluate pay for performance alignment for purposes of developing its vote recommendation on management say on pay (MSOP) proposals. For Russell 3000 companies, ISS will initially determine whether a company has demonstrated a strong, satisfactory or weak alignment between TSR and CEO pay over an extended period (Quantitative Analysis). Under the Quantitative Analysis, ISS will assess CEO pay relative to peer group companies by applying two measures of relative alignment and one absolute alignment measure that will assess the trend of CEO pay against the trend of the subject company's TSR. If the Quantitative Analysis determines that the alignment between a company's TSR and CEO pay is weak, ISS will then subject the company to a more in-depth qualitative analysis (Qualitative Analysis).

ISS' technical document provides the following guidance on its new methodology for evaluating CEO pay for performance alignment.

### Relative Alignment

- How will ISS measure the degree of relative alignment between the company's TSR rank and CEO total pay with the company's ISS developed peer group, as measured over one-year and three-year periods (Relative Degree of Alignment)?
  - One- and three-year pay amounts (annual and average, respectively) for each peer company are based on the most recently disclosed three years of pay data available in ISS' ExecComp Analytics database for that company. Annualized TSR performance for the subject company and peer companies will be measured for the same period.
- How will ISS evaluate the multiple of the CEO's total pay relative to the peer group median (Multiple of Median)?
  - Calculating this measure is straightforward; a CEO total pay is divided by the median pay for the peer group.
- What is the process by which ISS will develop its peer groups for purposes of these relative alignment tests?
  - In developing a subject company's peer group, ISS will first generate a group of potential peer companies that have the following attributes: (i) the same 2-digit GICS code as the subject company, (ii) annual revenues of between 0.45 times to 2.1 times the subject company's annual revenues (assets for financial companies) and (iii) market capitalization of between 0.2 times and 5 times the subject company's market capitalization. ISS will then select from the group of potential peer companies those companies that are in the subject company's 6-digit GICS code. If ISS is unable to develop at least a 14 company peer group after this selection process, ISS will then select from the group of potential peer companies those companies that are in the subject company's 4-digit GICS code to form at least a 14 company peer group. Where possible, the developed peer group's median revenues should approximate the annual revenues of the subject company.
- What is the method of scoring the Relative Degree of Alignment and Multiple of Median measures?
  - Values for the Relative Degree of Alignment measure range between -100 and +100, with -100 representing the high pay for low performance (i.e., 100<sup>th</sup> percentile pay combined with 0<sup>th</sup> percentile

performance), zero representing a high degree of alignment (the pay rank is equal to the performance rank) and positive values representing high performance for low pay.

— Values for the Multiple of the Median can range from zero (if the subject company paid its CEO nothing) to infinity.

- What are levels that may trigger high concern with regard to the aforementioned quantitative measures?

— ISS will use the following matrix to determine whether its quantitative analysis triggers high concern and therefore, subjects a company to additional qualitative analysis:

Relative Alignment Measure	Level that may trigger high concern in conjunction with other measures	Level that may trigger high concern by itself
Relative Degree of Alignment	-30	-50
Multiple of Median	2.33 x	3.33 x

### Absolute Alignment

- How will ISS measure the absolute alignment between the trend in CEO’s pay and the company’s TSR over the prior five fiscal years (Absolute Alignment)?

— At a high level, the measure is calculated as the difference between the slopes of weighted linear regressions for CEO total pay and for shareholder returns over a five-year period. This difference indicates the degree to which CEO total pay has changed more rapidly than shareholder returns over that period.

- What are the levels that may trigger high concern with regard to the Absolute Alignment measure?

— ISS will use the following matrix to determine whether its quantitative analysis triggers high concern and therefore, subjects a company to additional qualitative analysis:

Absolute Alignment Measure	Level that may trigger high concern in conjunction with other measures	Level that may trigger high concern by itself
Pay-TSR Alignment	-30%	-45%

### Qualitative Analysis

In cases where CEO pay for performance appears weak based on the Qualitative Analysis, ISS will undertake a further in-depth qualitative analysis to determine causal or mitigating factors relating to apparent pay misalignment.

- How will ISS apply the qualitative factors for assessing pay for performance disconnects when the alignment between pay and performance appears weak based on its quantitative assessment?

— A key consideration in the qualitative assessment is the ratio of performance- to time-based equity awards as well as the overall ratio of performance-based compensation to total compensation. A

company that exhibits significant misalignment of pay and performance over time would be expected to strongly emphasize performance-based compensation.

- If a company exhibits a long-term disconnect between pay and performance, ISS will closely examine a subject company's benchmarking approach to determine whether that may be a contributing factor. For example, a preponderance of self-selected peers that are larger than the subject company may drive up compensation without regard to performance. Above-median targeting may have the same effect.

If the Qualitative Analysis indicates a pay for performance disconnect exists, then ISS will likely recommend against a company's management say on pay proposal and may recommend against a management proposal to adopt a new equity plan or increase the share authorization under an existing plan.

**Meridian comment.** *The modifications to GRId and to the methodology for evaluating CEO pay for performance has significantly increased the complexity of both of these ISS policies. We will be examining GRId 2.0 and the revised pay for performance methodology in much greater detail in future Client Updates.*

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