

# Meridian Client Update

## Detailed Analysis of Institutional Shareholder Services' New 2012 CEO Pay for Performance Methodology

On December 21, 2011 we issued a Client Update that highlighted the key aspects of Institutional Shareholder Services' (ISS') white paper on its new methodology for evaluating CEO pay for performance. This Client Update provides an in-depth look at this new methodology and the guidance provided under the ISS white paper.

### Overview of New Pay for Performance Methodology

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. For Russell 3000 companies, ISS will initially perform the following two-part quantitative analysis to determine whether a disconnect exists between CEO pay and a company's total shareholder return (TSR) performance (capturing stock price appreciation and dividends) over an extended period:

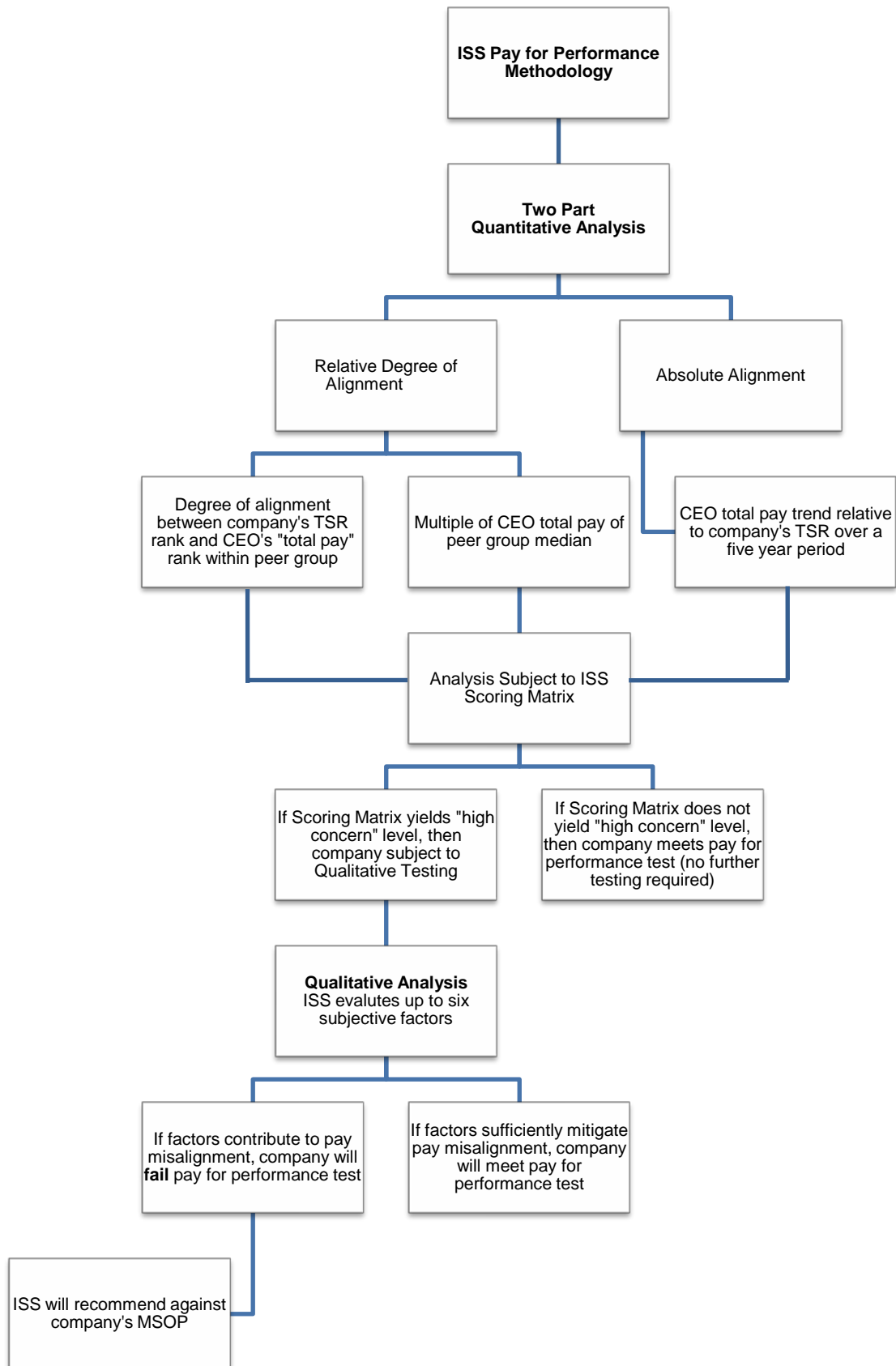
- **Part I: Relative Alignment Analysis:** Under the relative alignment analysis, ISS will determine:
  - The degree of alignment between a subject company's TSR rank and the CEO's total pay rank within an ISS composed peer group, as measured over one- and three-year periods (weighted 40%/60%, respectively); and
  - The multiple of the CEO's total pay relative to the peer group median.
- **Part II: Absolute Alignment Analysis:** Under the absolute alignment analysis, ISS will determine the difference between the trend in annual changes in CEO total pay and the trend in the subject company's annualized TSR over the prior five fiscal years.

The outcomes from the foregoing analyses are assessed through ISS' scoring matrix to determine whether a "high" concern level exists with respect to a pay for performance disconnect. If the scoring matrix yields a high concern level, then ISS will assess up to six subjective factors (the "Qualitative Analysis") to identify whether a subject company's pay practices mitigate or facilitate the perceived disconnect between pay and performance.

A company's failure to meet the pay for performance test will impact ISS' vote recommendations in the following ways:

- ISS will recommend a vote AGAINST the company's "Say on Pay" proposal.
- If no management say on pay proposal is on the corporate proxy, then ISS will recommend a vote to WITHHOLD on Compensation Committee members (or, all board members if they are deemed accountable for the pay and performance disconnect).
- ISS may recommend a vote AGAINST a company's proposal seeking shareholder approval on (i) the adoption of a new equity plan or (ii) an increase in an equity plan's share authorization.

ISS' new pay for performance methodology is illustrated below.



ISS' technical white paper provides extensive guidance regarding its new CEO pay for performance methodology. The white paper also discusses ISS' "back-testing" of the Quantitative Analysis portion of the pay for performance methodology. ISS conducted this back-testing by analyzing pay and performance data for 2,500 companies from the years 2006-2010. Not surprisingly, the back-testing demonstrated the validity of the various individual quantitative analyses required under the new methodology. We highlight selected back-testing results in our discussion below. We also provide a detailed step-by-step guide as to the application of the new CEO pay for performance methodology.

## Quantitative Analysis

The purpose of the Quantitative Analysis is to determine whether a company has demonstrated a **strong, satisfactory or weak alignment between total shareholder return (TSR) and CEO total pay over an extended period**. This determination is based on two relative measures of alignment (i.e., relative degree of alignment and CEO multiple of peer group median) and one absolute measure of alignment (i.e., CEO total pay against the trend of a subject company's TSR). To conduct these analyses, ISS first determines a company's peer group and CEO total pay.

### Step 1: Determination of Company's Peer Group

ISS will construct a peer group of between 14 and 24 companies for each subject company covered by the pay for performance methodology. Peer groups are generally constructed with reference to the subject company's industry (based on GICS classification), revenue (or assets with respect to financial companies) and market value. Peer groups for all Russell 3000 companies analyzed under this methodology are constructed twice per year, based on financial data provided by Standard & Poor's Research Insight as of December 1 and June 1 (i.e., quarterly download date or QDD). As of each QDD, a company's revenues will be based on the sum of the most recent trailing four quarters of revenues, total assets will be based on the most recent quarter's total assets and market capitalization will be the product of the company's 200-day average share price and the number of shares outstanding.

ISS will use the following process for selecting peer group companies:

- **Step 1A: Development of Potential Peer Companies.** A potential peer group is developed from companies that have the following attributes:
  - The same 2-digit GICS code as the subject company;
  - Annual revenues of between 0.45 times and 2.1 times the subject company's annual revenues or assets for financial companies; **and**
  - Market capitalization of between 0.2 times and 5 times the subject company's market capitalization.

Potential peer companies are identified from a universe of more than 4,000 companies (i.e., all component companies of the Russell 3000 index, supplemented by the publicly traded peers disclosed by Russell 3000 companies in their proxies).

- **Step 1B: The List of Potential Peer Companies is Narrowed to Companies Operationally Similar to Subject Company.** In this step, ISS will narrow the list of potential peer companies in the following manner:
  - Potential peer companies are narrowed to those in the subject company's 6-digit GICS category. If the peer group reaches the minimum 14 companies, it is considered complete; up to 24 peer companies may be selected from the 6-digit GICS category.

- If the foregoing selection process does not yield at least a 14 company peer group, then additional companies are selected from the group of potential peer companies that are in the subject company's 4-digit GICS code. If 14 peer companies cannot be selected using the 4-digit GICS, then the process is repeated using the 2-digit GICS category, until 14 peer companies are selected.
- If the foregoing selection process does not yield at least a 14 company peer group, then the peer group is expanded by relaxing the revenue (but not market cap) parameters in the peer group selection process.

Where possible, the median revenues of the peer group (median assets in the case of a financial company) are intended to approximate the annual revenues of the subject company. In exceptional cases, ISS will adjust a company's peer group where certain selected peer companies appear to be inappropriate (e.g., bankruptcy of a peer company).

- **Step 1C: Special Rule for “Super-Mega” Non-Financial Companies.** ISS has created a special peer group composed of approximately 25 “super-mega” non-financial companies within the Russell 3000 index. These companies have over \$50 billion in revenue and at least a \$30 billion market capitalization. This special peer group will be used for purposes of conducting the Quantitative Analysis for each company in the special peer group. Industry specific performance will also be considered in any resulting qualitative review.

## Step 2: Determination of CEO Total Pay

CEO total pay is determined by taking the sum of the following elements of compensation disclosed in the subject company's and peer companies Summary Compensation Tables set forth in their respective proxies:

- Salary;
- Bonus and/or non-equity incentive plan compensation;
- Stock awards (grant date fair value);
- Stock option awards (grant date fair value based on the full term of the option);
- Annual change in pension value;
- Above market earnings on nonqualified deferred compensation; and
- All other compensation.

As noted above, equity awards are valued at their **grant date fair value** for purposes of calculating CEO total pay. For stock awards, ISS will use the grant date fair value disclosed in the Summary Compensation Table. However, for award of stock options, ISS will not use the grant date fair value disclosed in the Summary Compensation Table. The Summary Compensation Table value is based, in part, on the expected life of the option. ISS determines the grant date fair value of an option based, in part, on the full term of the option. This valuation approach yields a greater value than the one disclosed in a company's Summary Compensation Table.

### Step 3: Relative Degree of Alignment Analysis

To determine relative degree of alignment of CEO total pay to performance, ISS will undertake the following steps:

- **Step 3A: Determine CEO Pay Data.** One- and three-year CEO total pay (annual and average, respectively) for each peer company is derived from the most recently disclosed three years of CEO pay data available in ISS' ExecComp Analytics database for each peer company.
- **Step 3B: Determine Annualized TSR Data.** One- and three-year annualized TSR data for the subject company and peer companies is measured for the same period (i.e., the one- and three-year periods ending on the last day of the month closest to the fiscal year-end of the subject company).
- **Step 3C: Calculate Subject Company's TSR rank.** The subject company's TSR percentile rank relative to the peer group is calculated for the one- and three-year periods.
- **Step 3D: Calculate CEO's Total Pay Rank.** The subject company's CEO total pay percentile rank relative to the peer group is calculated for the one- and three-year periods.
- **Step 3E: Calculate Combined Percentile Ranks.** Combined percentile ranks for CEO total pay and for TSR performance are calculated based on a 40% weighting for rankings attributable to the one-year measurement period and a 60% weighting for rankings attributable to the three-year measurement period.
- **Step 3F: Calculate Relative Degree of Alignment Measure.** A subject company's Relative Degree of Alignment measure is determined by subtracting from its combined TSR performance rank the company's combined CEO total pay rank. If three years of data are not available for the subject company, the combined measure will reflect only the one-year rankings. Values for the Relative Degree of Alignment measure may range between -100 and +100, with -100 being the worst score, representing high pay for low performance (i.e., 100<sup>th</sup> percentile pay combined with zero percentile performance). Zero represents a high degree of alignment (the pay rank is equal to the performance rank), and positive values representing high performance for relatively low pay. The following table illustrates the determination of combined measure and the value its yields for Relative Degree of Alignment measure:

	TSR Performance Percentile Ranking	Total CEO Pay Percentile Ranking	Combined Unweighted Difference	Combined Weighted Difference
1-year (40% weight)	54	47	7	3
3-year (60% weight)	36	52	-16	-10
Relative Degree of Alignment Value				-7

#### Step 4: Multiple of Median Analysis

The second relative alignment assessment is the multiple of median analysis. To conduct this analysis, ISS will undertake the following steps:

- **Step 4A: Determination of Peer Group Median.** The median CEO total pay is determined for the peer group.
- **Step 4B: Determination of Multiple of Peer Group Median.** The subject company's CEO total pay is divided by the median CEO total pay for the peer group to yield the multiple of median measure. Multiples may range from zero (if the subject company did not pay its CEO any compensation) to infinity.

In ISS' back-testing analysis, both the median and modal values for the multiple of median measure were almost exactly 1.0; meaning that the typical company in the back-test sample pays very close to the median CEO total pay of the ISS-selected peer group. In addition, ISS back-testing showed that the highest observed multiple was just over 25 times peer median.

#### Step 5: Absolute Alignment Analysis

The purpose of the absolute alignment analysis is to compare CEO total pay and the subject company's TSR trend to determine whether shareholders' and executives' experiences are directionally aligned.

To conduct this absolute alignment analysis, ISS will undertake the following steps:

- **Step 5A: Pay Regression Analysis.** A pay regression analysis is performed based on five values that are measured, at years 1, 2, 3, 4 and 5. The dependent (y) values for the pay regressions are CEO total compensation values for each of the five most recent fiscal years which are plotted against the independent (x) variable time.
- **Step 5B: TSR Regression Analysis.** A TSR regression analysis is performed based on six values that are measured, at years 0, 1, 2, 3, 4 and 5. The dependent (y) values for the TSR regression are determined by hypothetically "investing" \$100 in the subject company on the day five years prior to the most recent fiscal year end, and measuring the value of that \$100 investment on each of the subsequent five year fiscal year end dates, for a total of six indexed TSR values which is plotted against the independent (x) variable time.
- **Step 5C: Determine Slope of Both Regression Analyses.** The slope of each regression analysis is determined in accordance with an ISS specified formula.
- **Step 5D: Calculate Absolute Alignment Measure.** The determination of the absolute alignment of pay and performance is based on a comparison between the TSR slope and the Pay slope (i.e., TSR slope minus Pay slope). This difference between these two slopes indicates the degree to which CEO total pay has changed more rapidly (or less rapidly) than shareholder returns over the measured five-year period. Potential values for this difference range from just over -100% to just over 100%, with a slightly median negative value.

The type of regression technique employed by ISS is referred to as a weighted least-squares regression. It is beyond the scope of this Client Update to discuss the intricacies of this type of regression or how ISS fully employs it in the foregoing analyses. For additional information regarding the regression techniques employed by ISS, please consult Appendix II of the ISS technical white paper on its pay for performance methodology.

### Step 6: Determination of Level of Concern - Scoring Matrix

The three measures (i.e., Relative Alignment measure, Multiple of Median measure and Absolute Alignment measure) developed under the Quantitative Analysis provide the raw scores for ISS' quantitative assessment of a subject company's pay for performance alignment. ISS has developed a framework to determine whether these measures indicate the presence or absence of a potential pay for performance disconnect. This framework identifies whether (1) a single measure is a sufficient outlier to demonstrate a likely pay-for-performance disconnect by itself, or (2) a single measure is a sufficient outlier to demonstrate a potential pay-for-performance disconnect in conjunction with one or both of the other measures.

The table below shows the levels for each measure that indicate when a company would be considered an outlier (triggering medium concern) or a significant outlier (which would trigger high concern). High concern for any individual measure **will** result in an overall high concern level under the Quantitative Analysis, and multiple medium concern levels **may** also result in an overall high concern level.

Measure	Level that may trigger high concern in conjunction with other measures	Level that triggers high concern by itself
Relative Degree of Alignment	-30	-50
Multiple of Median	2.33x	3.33x
Absolute Alignment	-30%	-45%

A company that scores a high concern level will be subject to ISS' Qualitative Analysis. Companies that score below the high concern level will not be subject to further analysis and will be considered to have satisfied the ISS pay for performance evaluation.

***Meridian comment: The principal issue surrounding ISS' extensively engineered Quantitative Analysis is its efficacy in measuring the link between CEO pay and company performance. ISS notes in its white paper the challenges of drawing a link between CEO and company TSR performance. According to ISS these challenges arise from a variety of factors including the fact that (i) pay and TSR are measured differently; (ii) pay and TSR are measured on different scales and different timeframes; (iii) pay is "lumpy," with significant swings on a year-to-year basis that can obscure long-term trends; and (iv) TSR measurements, even over the long-term, are sensitive to the endpoints of the periods being measured. ISS asserts that these difficulties have been overcome through the new Quantitative Analysis and that its back-testing proves this point. However, we wonder how truly effective ISS will be in measuring the link between pay and performance when it measures CEO total pay based on a mixture of actual and potential compensation.***

***On a more practical note, we believe the ISS white paper provides sufficient technical guidance that a Russell 3000 company should be able to determine its ISS peer group in advance. Once the peer group is developed, a company should be able to run the various analyses required under the Quantitative Analysis portion of ISS' pay for performance test. The outcome of these tests***

***should enable a company to determine whether it passed the pay for performance test or is subject to further scrutiny under the Qualitative Analysis. Meridian consultants are available to run each of these ISS tests for individual companies.***

## **ISS' Qualitative Analysis**

As noted above, where a company scores a high concern level under the Quantitative Analysis, ISS will undertake a further in-depth Qualitative Analysis to determine causal or mitigating factors relating to apparent pay misalignment. Under the Qualitative Analysis, ISS will consider some or all of the following unweighted factors to determine how various pay elements may work to encourage or to undermine long-term value creation and alignment with shareholder interests:

- **The ratio of performance- to time-based equity awards and the ratio of performance-based compensation to overall compensation.** A company that exhibits significant misalignment of pay and performance over time would be expected by ISS to strongly emphasize performance-based compensation. This should not be achieved by simply increasing the size of the CEO pay package to make it more performance-based. Time-based awards, including time-based restricted stock and stock options, are not considered performance-based compensation in this context.
- **The completeness of disclosure and rigor of performance goals.** ISS expects companies to fully disclose performance metrics and goals, which should be reasonably challenging in the context of its past performance and goals, guidance the company has provided to analysts, etc. Use of a single metric, or similar metrics, in either or both of a company's short- and long-term incentive programs may suggest inappropriate focus on one aspect of business results at the expense of others. If the company uses non-GAAP metrics, adjustments should be clearly disclosed (along with compelling rationale if such adjustments are nonstandard).
- **The company's peer group benchmarking practices.** If a company exhibits 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.
- **Actual results of financial/operational metrics, such as growth in revenue, profit, cash flow, etc., both absolute and relative to peers.** ISS may examine recent financial metrics such as return measures and growth in revenue, profit and cash flow, both absolute and relative to peers, to assess the rigor of performance goals and whether the results of the Quantitative Analysis may be anomalous (if other metrics suggest sustained superior performance).
- **Special circumstances.** ISS may consider exceptional situations, such as recruitment of a new CEO in the prior fiscal year or unusual equity grant practices (e.g., bi- or triennial awards) that may distort the Quantitative Analysis. However, ISS notes that such circumstances do not automatically invalidate other aspects of the analysis, including the Quantitative Analysis, since that methodology's long-term orientation is designed to smooth the impact of timing anomalies. Further, in ISS' view, while shareholders may welcome a new CEO in light of lagging performance, they may nevertheless be concerned about a board that has been forced to pay heavily for outside talent but fails to appropriately link the new CEO's pay to performance improvement.

***Meridian comment: The qualitative factors are a blend of new and old concerns of ISS. This influential shareholder advisory group has previously advocated for the increased use of performance-based compensation, against disproportionate granting of time-vested equity compensation, and for robust proxy disclosure of compensation programs. Clearly, current compensation trends and design practices at large public companies positively reflect these qualitative factors.***

***The remaining qualitative factors are new for ISS and may prove problematic for many companies. These factors are particularly focused on the rigor of performance goals. Companies will need to demonstrate that their performance goals are “reasonably” challenging in the context of prior performance, guidance and other relevant benchmarks. This type of disclosure is not required under the proxy rules, except in the case where a company chooses not to disclose its performance goals. Voluntary disclosures regarding the rigor of performance goals have tended to be clichéd. It is unclear whether large public companies will embrace ISS’ notions around disclosing the rigor of performance goals. Many also doubt ISS’ ability to determine the rigor of performance goals on its own.***

***Another new qualitative factor is ISS’ evaluation of a company’s peer group used to benchmark compensation. ISS clearly favors peer groups with median revenues that approximate the revenues of the subject company. Similarly, ISS favors benchmarking compensation against median pay levels of the peer group. Many public companies’ pay philosophies already embrace the foregoing parameters. However, for those companies operating outside those parameters, ISS undoubtedly expects a disclosure explaining the appropriateness of such companies’ peer group and pay philosophy. Perhaps most problematic is the use of regression to size-adjust data derived from a custom peer group. This is a common technique employed by large public companies that use custom peer groups with median revenues significant greater or less than the revenues of the subject company. It is unclear the approach ISS will take in evaluating this circumstance. ISS could possibly require companies to make extensive disclosures regarding the methods used to size-adjust data. Currently, such disclosure is not a common practice.***

***ISS’ application of the Qualitative Factors is inherently subjective and will be affected by a company’s particular facts and circumstances. However, companies will not be operating in the dark. Despite the lack of guideposts, we believe that with a reasonable degree of effort, companies should be able to assess their pay programs under each of the qualitative factors.***

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