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A guide to ISS's 2021 pay-for-performance assessment

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Institutional Shareholder Services (ISS) has updated its approach to evaluating US companies' CEO pay and performance alignment under its [2021 US Proxy Voting Guidelines](#). The [pay-for-performance assessment](#) is a key driver of the proxy adviser's recommendations on say on pay (SOP) and other proxy voting issues. If the assessment would result in a negative voting recommendation but there's no SOP proposal on the proxy ballot (e.g., where the company has adopted a biennial or triennial SOP vote), ISS will recommend against members of the compensation committee or potentially the full board. And a negative outcome may affect ISS's voting recommendation for a company's equity plan proposal if there's one on the ballot. This article describes the quantitative tests and qualitative factors ISS uses in the assessment.

Pay-for-performance assessment overview

ISS bases its SOP voting recommendations on a two-part pay-for-performance assessment: quantitative and qualitative. See the chart in [Appendix A](#) for an overview of the assessment approach.

Quantitative evaluation. ISS's quantitative evaluation uses three primary tests and one secondary test:

- Three primary tests:
 - Relative Degree of Alignment (RDA): RDA measures the difference between the company's annualized total shareholder return (TSR) percentile ranking and its CEO's average total pay percentile ranking over a three-year period relative to a peer group selected by ISS. For example, a company with TSR at the 40th percentile of the peer group and CEO pay at the 60th percentile would have an RDA of -20.
 - Pay-TSR Alignment (PTA): PTA uses regression analysis to measure the absolute alignment of five-year trends in the company's CEO annual total pay relative to its TSR.
 - Multiple of Median (MOM): MOM expresses the CEO's pay as a multiple of the ISS-selected peer group median for the most recently disclosed year. In addition, research reports include a three-year MOM view of CEO pay for informational purposes, which may inform ISS's qualitative evaluation.

- Secondary test: Financial Performance Assessment (FPA) based on Economic Value Added (EVA) metrics: FPA measures the difference between the company's financial performance across four EVA financial metrics and its CEO's average total pay percentile ranking over a three-year period relative to the ISS-selected peer group.

Pay is based on the CEO's total compensation as it appears in the summary compensation table (SCT) of a company's most recent proxy statement, with some exceptions. For example, ISS calculates option values assuming they will be exercised at the contractual term's end, instead of using the grant-date fair values included in the SCT.

The scores from the three primary tests result in a combined initial quantitative concern level and the addition of the secondary test results in an overall quantitative concern level for a company's pay program. Concern levels are "low," "medium," or "high". A higher overall quantitative concern level triggers a higher level of scrutiny in the qualitative evaluation.

Qualitative evaluation. The qualitative evaluation assesses how pay elements may encourage or undermine long-term shareholder value creation, including the strength of performance-based pay and rigor of performance goals, financial and operational metric results, realized and realizable pay, peer group pay benchmarking practices, executive transitions, and special circumstances. A favorable result under the qualitative evaluation can mitigate a high or medium quantitative concern level and garner a positive SOP voting recommendation. Conversely, a poor result under the qualitative evaluation can trigger a negative voting recommendation, regardless of a company's quantitative concern level.

Separate from the pay-for-performance assessment, ISS tracks certain "[problematic pay practices](#)," which, by themselves, can trigger a negative recommendation.

Key methodology changes for 2021

ISS released a stand-alone set of [FAQs](#) explaining how it will consider the exceptional circumstances of the COVID-19 pandemic and its impact on company operations in its qualitative evaluation. For more information on this guidance, see Mercer's article: [ISS Issues COVID-related Executive Pay FAQs](#).

Other updates, effective for shareholder meetings held on or after Feb. 1, 2021, are modest:

- The MOM high concern threshold for S&P 500 companies will decline from 3.33x to 3x the peer median. Historically, few companies have triggered a high concern under this test, and it's unlikely the lowered threshold will impact many companies.
- The threshold scoring levels for the PTA test for all companies and the MOM test for S&P 500 companies that trigger eligibility for an FPA adjustment have been tweaked. As with the change to MOM, these very small changes won't impact many companies.

In addition, ISS no longer provides draft reports to S&P 500 companies for review before publication. The proxy adviser has indicated that companies were using the draft report process to "lobby" investors

regarding ISS policy rather than finding errors. Of note, before this change, the SEC adopted a rule that, beginning in 2022, would require proxy advisers to give companies a chance to respond to reports, by providing the response (or a link to an SEC supplemental filing) to investors before they vote, see Mercer's article: [New SEC rule regulates proxy advisers](#). (This rule could be reversed by the SEC under the new administration.)

Details of the quantitative evaluation

As described above, the quantitative evaluation consists of two steps:

- Step 1: Generates an initial concern level based on the three primary tests: RDA, PTA, and MOM
- Step 2: Generates an overall concern level, which may be different than the initial concern level if affected by the FPA

Step 1: Three primary tests

A summary of the key features of the three primary tests is shown in the following table.

| Test | Relative/Absolute* | Years covered | Inputs |
|---|--------------------|---------------|-----------------|
| Initial quantitative assessment: primary tests | | | |
| Relative degree of alignment (RDA) | Relative | 3** | CEO pay and TSR |
| Pay-TSR alignment (PTA) | Absolute | 5*** | CEO pay and TSR |
| Multiple of median (MOM) | Relative | 1 | CEO pay |

*Relative comparisons are against ISS-selected peers (see [Appendix B: Peer group selection](#) for a discussion of how ISS selects peer companies for the relative tests).

**RDA test won't be run with less than two years of data.

***PTA test won't be run with less than four years of data

For the RDA and PTA tests, the TSR calculation:

- Uses the period (three years for RDA and five years for PTA) ending closest to the fiscal year-end of the subject company. This same period is used for both the subject company and its peers.
- Uses trailing average daily closing share prices for the month preceding the beginning and end of the measurement period. For example, the three-year TSR for the performance period Jan. 1, 2018, to Dec. 31, 2020, would use daily closing share prices for December 2017 as the starting point and daily closing prices for December 2020 as the end point.

- Assumes dividends are reinvested

See [Appendix C](#) for a Mercer illustration.

Initial quantitative concern thresholds. The following table shows the scores on the three primary quantitative tests that trigger initial medium and high concern levels:

| Initial quantitative concern thresholds for 2021 (vs. 2020) | | |
|---|-----------------------|---------------------|
| Test | Medium concern | High concern |
| RDA | -50 | -60 |
| PTA | -30% | -45% |
| MOM: | | |
| • All companies except S&P 500 | 2.33x | 3.33x |
| • S&P 500 companies | 2.00x | 3.00x (3.33x) |

If two or three of the initial concern tests result in a medium concern level, the overall initial quantitative result will be a high concern.

Step 2: FPA secondary test

A company's FPA score is based on CEO pay and performance alignment relative to the ISS peers on four EVA metrics measured over a three-year period. (The screen won't be run with less than two years of data.)

While an FPA score is calculated for all companies (with the exceptions noted [below](#)), it can affect the overall quantitative concern level only in limited cases, depending on the initial quantitative concern level described above, as shown in the following table:

| Initial concern thresholds triggering eligibility for FPA adjustment for 2021 (vs. 2020) | |
|--|---------------|
| RDA | -38 |
| PTA | -23% (-22%) |
| MOM: | |
| • All companies except S&P 500 | 1.74x |
| • S&P 500 companies | 1.67x (1.64x) |

An FPA adjustment can have one of the following impacts on an initial concern level:

- Initial medium concern: A good FPA score can reduce the overall concern level to low.
- Initial low concern with a borderline medium concern on any of the three primary tests: A poor FPA score can increase the overall concern level to medium.

A company triggering a high concern in Step 1 isn't eligible for an adjustment based on its FPA results.

EVA methodology details. EVA measures a company's economic profit, defined as net operating profit (revenue minus operating expenses) after tax (NOPAT), reduced by a capital charge (NOPAT – capital charge). The capital charge is calculated by multiplying the company's invested capital by its cost of capital. According to ISS, EVA is superior to GAAP-based profit measures because it cuts through accounting distortions and charges for the use of capital. It starts with accounting figures from a company's financial statements, but adds and subtracts various items with the goal of making it more comparable across companies, industries, and countries. See Mercer's article: [Performance Measurement Spotlight: What You Need to Know About Economic Value Added](#).

The ISS EVA methodology uses four equally-weighted EVA financial metrics, measured against the ISS-selected peer group, as described in the following table:

| Metric | Definition | Period covered |
|--|--|---|
| EVA Margin (EVA ÷ Sales) | EVA as a percent of sales | 12 most recent trailing quarters (minimum 8) |
| EVA Spread (EVA ÷ Capital) | EVA yield on capital: the spread between company's return on capital and cost of capital | 12 most recent trailing quarters (minimum 8) |
| EVA Momentum vs. Sales (Δ EVA ÷ Prior Sales) | Annual growth rate in EVA over past three years, relative to sales | 16 most recent trailing quarters (minimum 12) |
| EVA Momentum vs. Capital (Δ EVA ÷ Prior Capital) | Annual growth rate in EVA over past three years, relative to capital | 16 most recent trailing quarters (minimum 12) |

The four metric performance ranks are averaged and compared to the CEO pay rank, similar to the RDA methodology, and then grouped into quartiles.

Company financial data is obtained from S&P Compustat, based on reported rather than adjusted financial statements. Companies can download their EVA profile from ISS at no cost.

Exceptions. The FPA test doesn't apply, or may be modified, in certain cases, including for real estate investment trusts; companies with less than two years of CEO pay or financial history; companies with

limited reported revenue or capital; as a result of merger, acquisition, and spinoff activity; and for periods where revenue or capital were below \$5 million.

Details of the qualitative evaluation

While the quantitative evaluation focuses on the CEO, the qualitative evaluation may extend to pay levels and practices for other proxy named executive officers. It considers but isn't limited to the following factors:

Strength of performance-based compensation. ISS expects a company that exhibits significant misalignment of pay and performance over time to "strongly emphasize" performance-based compensation — that is, pay that's based on attainment of pre-set goals. ISS will assess the rigor and nature of performance goals, including:

- Adequate ratio of performance- to time-based equity awards (ISS doesn't consider stock options as performance based)
- Overall ratio of performance-based to discretionary or fixed pay, focusing on the most recent compensation committee decisions
- Degree of challenge indicated by goals relative to past performance and goals, and guidance provided to analysts
- If goals are set lower than the prior year, the rationale for doing so and corresponding adjustments to pay opportunities
- Avoidance of a single metric or similar metrics for both short- and long-term incentives
- Clear disclosure of non-GAAP metrics, including adjustments to GAAP metrics, rationale for their use, and whether adjustments are nonstandard and/or within management's control

Financial/operational performance. In addition to the FPA used in the quantitative evaluation, ISS may consider a company's general financial performance to provide context for incentive opportunities and payouts. For example, ISS notes that strong results for a performance metric may justify above-target payouts despite poor TSR.

Realized and realizable pay. While SCT pay is used for the quantitative evaluation, the qualitative evaluation considers compensation realized from equity and performance awards. For S&P 1500 companies, ISS also reviews "realizable" pay, which may be a positive factor if it demonstrates that pay and performance are aligned.

Peer group pay benchmarking practices. ISS considers a company's pay benchmarking practices to determine whether they contribute to pay and performance misalignment. For example, a peer group

consisting mostly of companies that are larger than the subject company, or a philosophy of targeting above-median pay could inflate pay without regard to performance.

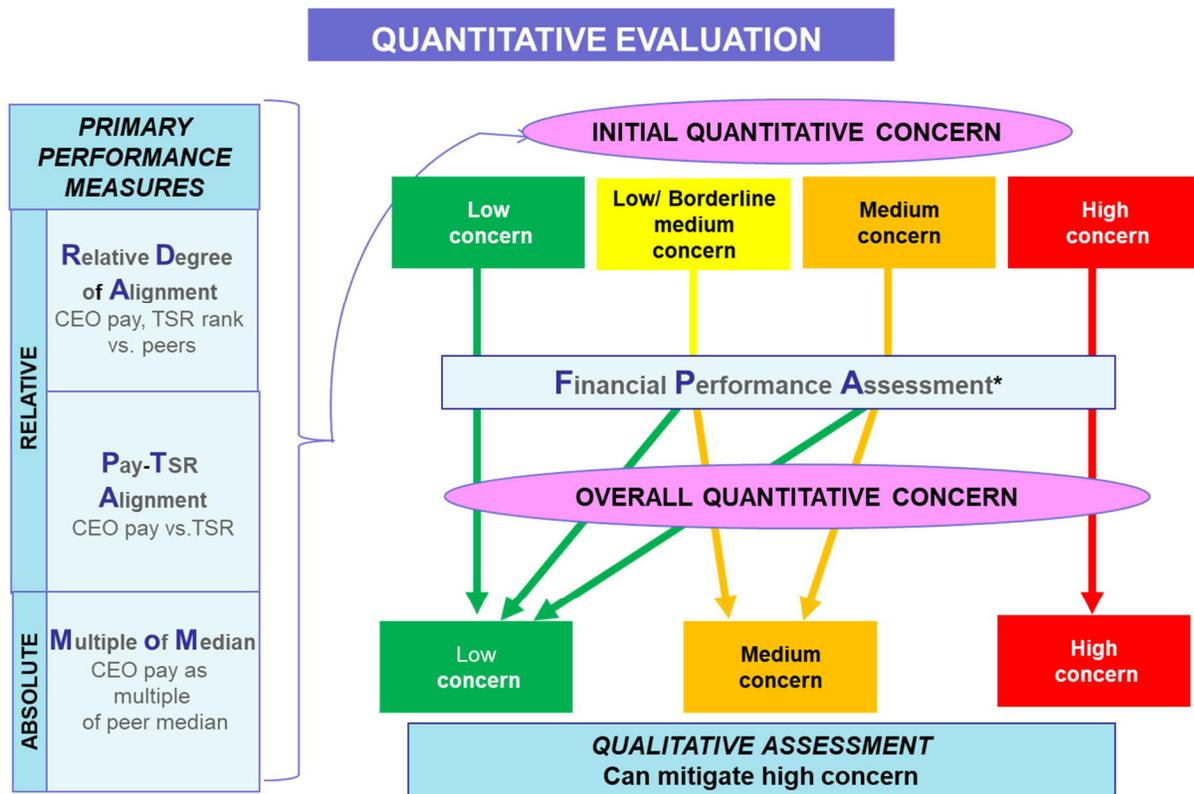
Executive transitions. ISS evaluates pay packages for both outgoing and incoming CEOs, and sometimes other executives. For outgoing executives, ISS looks at severance and treatment of equity awards on termination. For new executives, ISS considers sign-on awards and whether the pay package links pay and performance.

Special circumstances. ISS considers special circumstances, such as:

- The company's past response to low SOP votes (e.g., support below 70% will result in greater scrutiny)
- History of poor pay practices
- Unusual equity grants (such as special one-time grants or grants made every two or three years) to the CEO or other proxy named executive officers

COVID-19 impact. For now ISS will consider the exceptional circumstances of the COVID-19 pandemic and its impact on company operations, under guidance that provides few specifics regarding what pay-related actions it will deem "acceptable" or "not acceptable". For more information on the guidance, see Mercer's article: [ISS Issues COVID-related Executive Pay FAQs](#).

Appendix A: ISS pay-for-performance assessment



*Financial Performance Assessment (FPA) applies to all companies, but can only affect overall quantitative concern level for companies with an initial quantitative concern level of “medium,” or “low” with borderline medium on at least one of the 3 primary tests. FPA may move low/borderline concern up to medium or medium concern down to low.

The quantitative evaluation is followed by a qualitative evaluation covering policies and practices such as the proportion of compensation allocated to performance-based vehicles, rigor of performance goals, operating performance, realized and realizable pay, and peer group benchmarking. While all companies are subject to a qualitative evaluation, the quantitative concern level determines the depth of ISS’s qualitative evaluation, and the qualitative evaluation can affect a company’s overall evaluation. For example, a favorable qualitative evaluation can mitigate a “high concern” resulting from the quantitative evaluation, and result in a favorable SOP recommendation from ISS. Conversely, a poor qualitative evaluation can cause a medium concern to trigger a negative recommendation.

The outcome of the complete pay-for-performance assessment (quantitative and qualitative) determines ISS’s recommendation for or against the company’s SOP proposal or for or against the election of directors if there’s no SOP proposal on the ballot.

Appendix B: Peer group selection

ISS's peer group selection process is described in its [US peer group FAQs](#). ISS uses a peer group of 12 to 24 companies selected on the basis of the following:

- Global Industry Classification Standard (GICS) code of the subject company
- GICS code of the company's disclosed pay benchmarking peers
- Size: revenue (assets for some financial companies) plus market capitalization

Order of priority

ISS aims to keep the subject company's size close to the median. Given that objective, and the size constraints described [below](#), peers are selected from the company's own peer group and from peers disclosed by the company's peers in the following order:

- Own 8-digit GICS group
- Peers' 8-digit GICS group
- Own 6-digit GICS group
- Peers' 6-digit GICS group
- Own 4-digit GICS group

The selection process prioritizes the following:

- Subject company's "first-degree" peers: those that are either in the company's own peer group or that have chosen the company as their peer
- Companies with numerous connections to first degree peers: choosing them as a peer or being chosen as a peer

In most cases, ISS's peers are different from a company's self-selected peers, and sometimes they are significantly different.

'Typical' peer groups

According to ISS, its methodology produces peer groups with the following features:

- The average company has about 78% of its potential ISS peers selected based on the 8-digit GICS code of the company or its self-selected peers.
- 43% of companies have an ISS peer group that overlaps at least 50% with their own.

- On average, ISS's peer group includes 40% of a company's self-selected peers.
- More than 85% of ISS peer groups keep the subject company within 20% of the peer group median size.

Size constraints

ISS uses the following size constraints in selecting peers:

- Revenue: 0.4 to 2.5 times the company's revenue (or assets, for certain financial companies)
 - Range is expanded for companies with revenue (assets) greater than \$10 billion or less than \$200 million
 - Companies smaller than \$100 million are treated as if they have \$100 million in revenue (assets)
- Market capitalization: Ranges are wider than for revenue (assets) because of the variability in market values. Companies are classified into market capitalization buckets as follows:

| Bucket | Low end (\$mil.) | High end (\$mil.) |
|--------|------------------|-------------------|
| Micro | 0 | 200 |
| Small | 200 | 1,000 |
| Mid | 1,000 | 10,000 |
| Large | 10,000 | No cap |

- Potential peers must fall between 0.25 times the low end and 4 times the high end of the company's market capitalization bucket
- Oil and gas company peers are selected based solely on market capitalization, which should be between 0.4 and 2.5 times the subject company's market capitalization

Timing and communicating with ISS

Peer groups are constructed in December for meetings held on or after Feb. 1. For meetings held after Sept. 15, peer groups are reconstructed during July and August.

Companies can use ISS's peer group [feedback](#) process to indicate changes to their self-selected peers from those covered by ISS's last report. Companies can also verify that ISS is using the correct peer list from its last proxy.

Appendix C: Mercer illustration of three primary quantitative tests

The following example prepared by Mercer illustrates ISS's methodology for the three primary quantitative tests — relative degree of alignment (RDA), pay-TSR alignment (PTA), and multiple of median (MOM). It assumes a 14-company peer group for subject company XYZ Co.

RDA

Step 1: Display, rank, and calculate percentiles for three-year TSR and CEO pay.

| TSR: 3 years | | | | CEO pay: 3-year average (\$mil.) | | | | | | |
|--------------|-------|------|-----------------|----------------------------------|-------|-------|-------|---------|------|-----------------|
| Company | TSR | Rank | Percentile Rank | Company | 2020 | 2019 | 2018 | Average | Rank | Percentile Rank |
| A | 5.5% | 6 | 62% | A | \$2.5 | \$2.1 | \$2.1 | \$2.23 | 1 | 100% |
| B | 5.3% | 7 | 54% | B | \$2.3 | \$1.2 | \$1.4 | \$1.63 | 6 | 62% |
| C | 14.0% | 1 | 100% | C | \$2.0 | \$2.0 | \$2.1 | \$2.03 | 2 | 92% |
| D | 10.0% | 2 | 92% | D | \$1.9 | \$1.5 | \$1.6 | \$1.67 | 5 | 69% |
| E | 7.0% | 3 | 85% | E | \$1.8 | \$1.9 | \$1.8 | \$1.83 | 3 | 85% |
| F | 6.0% | 5 | 69% | F | \$1.7 | \$1.8 | \$1.8 | \$1.77 | 4 | 77% |
| G | 5.0% | 8 | 46% | G | \$1.5 | \$1.4 | \$1.5 | \$1.47 | 8 | 46% |
| H | 4.0% | 9 | 38% | H | \$1.4 | \$1.6 | \$1.5 | \$1.50 | 7 | 54% |
| I | -5.0% | 14 | 0% | I | \$1.3 | \$1.2 | \$1.4 | \$1.30 | 9 | 38% |
| J | 3.5% | 10 | 31% | J | \$1.3 | \$1.0 | \$1.0 | \$1.10 | 11 | 23% |
| K | 6.5% | 4 | 77% | K | \$1.2 | \$1.1 | \$1.1 | \$1.13 | 10 | 31% |
| L | 3.0% | 11 | 23% | L | \$1.0 | \$1.1 | \$1.0 | \$1.03 | 12 | 15% |
| M | -4.0% | 13 | 8% | M | \$0.9 | \$0.9 | \$0.7 | \$0.83 | 14 | 0% |
| N | -3.5% | 12 | 15% | N | \$0.8 | \$0.9 | \$1.0 | \$0.90 | 13 | 8% |
| XYZ Co. | 4.0% | | 38% | XYZ Co. | \$1.6 | \$1.5 | \$1.7 | \$1.60 | | 60% |

Step 2: Calculate the difference between the subject company's percentiles for performance and pay.

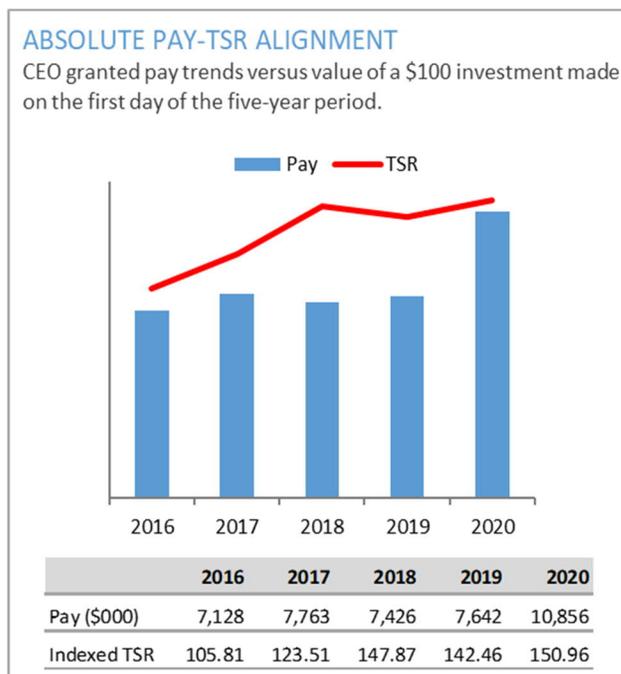
- Performance 38th percentile
- Pay 60th percentile
- **Difference = RDA -22**

The resulting RDA value is compared against a scale developed by ISS, ranging from -100 to +100, with negative 100 representing the highest pay for lowest performance. A score of zero represents a high degree of alignment (pay rank is equal to performance rank), and positive values represent high performance for low pay. In the example, the RDA is -22, which appears to be unfavorable, but because of ISS's scaling, it falls below the medium concern level.

PTA

This test uses regression analysis to evaluate the relationship between CEO pay and TSR over five years, weighted to reflect recent history. The final PTA measure is the difference between the performance slope and pay slope.

Although the results of the regression analysis for XYZ Co. are not shown here, the following graph illustrates the relationship in this example: TSR generally equals or exceeds CEO pay in each of the last four years, yielding a positive (favorable) PTA result.



MOM

In the example used above to illustrate RDA, the median of the peer group's 2020 CEO total pay is \$1.5 million, while at XYZ Co., the CEO's 2020 pay totaled \$1.6 million, or 1.07 times the median. Values can range from zero (if the subject company paid its CEO nothing) to — theoretically — infinity.

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