Pay for Performance Quantitative Screen (U.S. and Canada)

Background and Overview

ISS uses a number of quantitative pay-for-performance measures to identify companies where a potential pay-for-performance misalignment merits a deeper qualitative analysis of the pay program. The timeframe of these quantitative measures varies from five years (under the absolute pay-TSR alignment measure) to one year (under the multiple of peer pay median measure for pay magnitude). The Relative Degree of Alignment (RDA) measure takes a blended approach, combining one- and three-year measures of relative pay-TSR alignment.

Key Changes Under Consideration

ISS proposes to simplify the methodology for calculating its Relative Degree of Alignment (RDA) pay-for-performance screen. Currently this measure is calculated as the difference between the company's TSR rank and the CEO's total pay rank within a peer group, as measured over one-year and three-year periods (weighted 40%/60%, respectively).

The proposed new methodology is to calculate simply the difference between the company's TSR rank and the CEO's total pay rank within a peer group, as measured over a three-year period (or as many full fiscal years that the company has been publicly traded and disclosed pay data).

Intent and Impact

The proposed change stems from our belief and client feedback that a single three-year measure provides a better view on long-term pay and performance alignment and avoids being overwhelmed by periods of volatility and mean-reversion in the final year of the three-year period.

In addition, the ranking aspect at the heart of the RDA measure better matches a single, longer-term measure. This is best illustrated by an example of a company with two strong years of performance followed by lagging performance in the final year.

Period	Company TSR	TSR Rank in Peer Group (percentile)
2011	+25.0%	
2012	+22.0%	
2013	-8.0%	0
2011-2013 (annualized)	11.9%	100
Blended 1- and 3-year rank		60

While three-year performance remains at the top of the peer group, the blended 1- and 3-year TSR rank under the current methodology is only at the 60th percentile. The single 3-year measure thus better reflects the sustained long-term performance of this example company.

Using a single 3-year measure also diminishes effects from the timing of equity awards. Many companies grant equity early in the fiscal year, before the corresponding performance year. A longer-term "average" performance helps alleviate some of this timing mismatch, which is magnified especially given the effective weights currently placed on 1-year pay and performance.

This change is not intended to increase or decrease the number of companies that are identified as potential concerns by the RDA portion of the quantitative screen. Backtesting indicates that a small minority (under 7 percent) of companies with significant differences between their 1- and 3-year pay and/or performance will have RDA measures that are materially affected by this change.

Request for Comment

Please feel free to add any additional information or comments on the proposed policy change. In addition, ISS is specifically seeking feedback on the following:

1. Are there circumstances under which performance or pay from the most recent year should weigh more heavily in a pay-for-performance analysis?

2. Are there any unintended consequences from using a simple, unweighted three-year pay and performance measure as the basis for the RDA screen?

To submit a comment, please send via email to policy@issgovernance.com. Please indicate your name and organization for attribution. While ISS will consider all feedback that it receives, comments will not be published without attribution.

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