

***Comments on ISS Proposed Guidelines***

Peer Group Construction

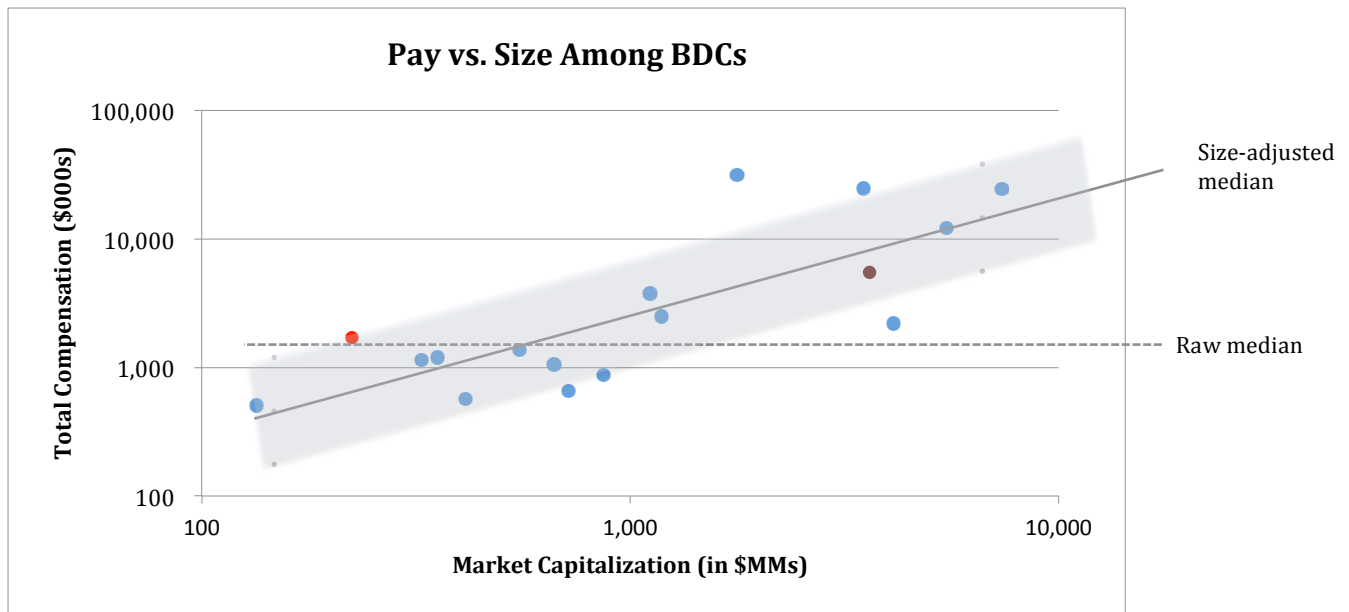
Peer group construction is an issue arising from the use of selected companies to establish percentiles based solely on the level of executive pay at those companies, what would be characterized as a one-dimensional analysis. ISS should recognize and encourage a two-dimensional analysis, as some of us are already doing, which creates percentiles based on the size of the selected companies as well as the level of pay. Such an analysis makes it easier to use a larger sample of more relevant firms, which in turn yields more robust and less manipulable results.

To illustrate the difference, we can view the list below showing a group of sixteen firms within an industry (in this case, business development/ investment companies) where the firms are plausibly competing for talent. A quick look confirms that larger firms generally pay more, illustrating the well-known lognormal relationship between company size and average pay that exists in nearly every industry:

Company	Total Comp. (000s)	Mkt Cap (MMs)
AMERICAN CAPITAL, LTD	\$5,501	\$3620
APOLLO GLOBAL MGMT	\$31,239	\$1777
BLACKSTONE GROUP LP	\$24,285	\$7376
CAPITAL SOUTHWEST CORP	\$569	\$413
CARLYLE GROUP	\$3,749	\$1113
COMPASS DIVERSIFIED	\$660	\$715
HARRIS & HARRIS GROUP	\$506	\$134
HERCULES TECH GROWTH CAP	\$1,372	\$552
ICAHN ENTERPRISES	\$2,185	\$4116
KKR	\$24,711	\$3510
KOHLBERG CAPITAL CORP	\$1,700	\$224
LEUCADIA NATIONAL CORP	\$12,166	\$5488
MAIN STREET CAPITAL CORP	\$876	\$869
MCG CAPITAL CORP	\$1,200	\$355
SAFEGUARD SCIENTIFICS INC	\$1,141	\$326
TRIANGLE CAPITAL CORP	\$1,051	\$665
<b>25th Percentile</b>	<b>\$1,007</b>	<b>\$398</b>
<b>50th Percentile</b>	<b>\$1,536</b>	<b>\$792</b>
<b>75th Percentile</b>	<b>\$7,167</b>	<b>\$3537</b>

The typical adjustment for the size/pay relationship involves two steps. The first is to reduce the number of firms on this list to a group of firms of more similar size. For any firm on this list, that would bring the number of peers down from sixteen to probably four or five. That would be far too few from which to expect statistically meaningful, let alone robust, results. To create a more respectable group, we must then expand to adjacent industries to aim for at least 15 to 20 firms. However, that requires judgments about which industry are “closest” to ours, and invariably moves us away from the standard of “plausible competition for talent.”

These problems could be overcome if the data of the table above were mapped onto a two dimensional (2D) chart like this:



In the above chart, the same sixteen pay points are spread across the market cap (the size metric that, for this industry, is the most highly correlated vs. pay). The dotted line straight across the chart represents the raw median of pay for the sixteen firms. The sloping solid line represents the line of “best-fit” for this data, i.e., the size-adjusted pay median across the full spectrum of companies. The shaded area represents the 25<sup>th</sup> to 75<sup>th</sup> percentile ranges around that size-adjusted median.

With regards to the above chart, we can make the following observations:

- The intuitive ranking of outliers is preserved in this 2D analysis. The red dot company (Kohlberg Capital) is clearly the highest paid relative to the companies close to it in size. That high relative pay is also shown in the size-adjusted analysis (just above the 75<sup>th</sup> percentile shaded area). The brown dot company (American Capital) looks obviously lower than other large companies. On a size adjusted basis, it is still below median, though not that far below.
- If we eliminated random dots (companies) from the above chart, it could significantly move the raw median line up or down, dramatically shifting the percentiles for any given company. That would be more true the fewer dots we have as if, for example, we were trimming companies too different from ours in size. However, elimination of random dots would have a more muted effect on the size-adjusted median line. In other words, deciding which companies to add or remove from a sufficiently large sample (even as few as sixteen) has much less affect on the 2D percentile data of any given firm. In other words, the results are more robust.
- Because the size-adjusted analysis is more robust, it is less prone to manipulation, and therefore would invite fewer attempts to do so. Any company that represents a plausible competitor for talent—whatever its size—is appropriate to include in such an analysis. Starting at about fifteen companies, the size-adjusted median becomes a fairly stable measure, meaning that cherry-picking one’s peers becomes much less rewarding.

- Since the size-pay relationship is fairly stable across industries, it becomes less important whether or not a given company is a suitable peer by virtue of its industry. Seeking firms from adjacent industries is unlikely to affect either the results or robustness of the analysis.

We perform this 2D analysis at our clients for many of their senior positions beyond CEO because it provides a better sense for how competitive they are for each position, and what they are getting for their money. We have shared this analysis with institutional investors, all of whom agree that it provides a more rational and robust benchmarking result than the typical '1D' analysis dependent on peer selection based solely on industry and size.

A final note: The purpose of peer benchmarking is to establish the *competitiveness and cost* of pay. In other words, it's an exercise in discovering labor market efficiency for the corporate client or issuer. The "pay" that is most relevant for evaluating the competitiveness and relative cost of compensation is *total expected* compensation.

- "*Total*" should ideally include all the elements of compensation, including salary, bonuses, the value of perks and benefits, etc. Benchmarking salaries, cash comp, etc. separately does not usefully distinguish either competitiveness or cost to the company when looked at in isolation.
- "*Expected*" should ideally be based on target levels of variable compensation, including bonuses, long-term incentives, etc. Since companies don't always disclose "target" levels of pay, or disclose them uniformly in an easily accessible table, we would use average pay over at least a three-year period as a reasonable proxy for "expected" levels of variable compensation. Benchmarking actual current pay without regards to performance distorts both the competitiveness and cost.

We recommend that a two-dimensional analysis based be formally recognized as a superior alternative in peer benchmarking of pay.

### Realizable pay

We suggest that the principle for determining realizable pay should be:

*What a third party would see as an executive's change in wealth from the beginning of some period to the end of that period, given an economic valuation of that executive's total, company-derived wealth.*

This wealth change criteria, properly calculated, is an economically sound basis for judging the net gain to an executive over a given period, and would make a comparison to performance (e.g., total shareholder return) relevant over that period.

We will assume for the following example that the period we are observing is one year. Thus, the elements of realizable pay (ignoring non-cash or equity elements) would be:

- Actual cash payments received during the year
- The grant-date value of equity received during the year
- The change in value of the granted equity during the year
- The change in value of all other company-granted equity held from the beginning of the year to the end of the year

With regards to stock options, for the latter two elements we mean the change in the economic (e.g., Black-Scholes) value.

Getting the data for the third and fourth elements would require some digging and analysis, and the results may not be precisely comparable across all firms due to some differences in

disclosure. The greatest challenge would be valuing long-term incentive compensation in the middle of the evaluation period, especially where the performance basis is something other than stock price. The best we may be able to do for that element is to use the realized award at the end of the evaluation period. We should ideally also discount the values for the likelihood of forfeiture to the extent that is not already recognized in the valuation.

All of these elements can be obtained from current disclosures, and therefore calculated with a reasonable degree of precision. If we wish to measure realizable pay versus performance in a single year, then we would sum these four elements for a one-year period and compare that to stock price (or other valid measure of) performance for that year. We can look at multiple periods, or even over the tenure of any executive using the same methodology.

In its purest form, this methodology provides an economically valid aggregation of pay over whatever period you may choose to compare pay to performance. The corollary is that it provides an economically valid disaggregation of pay, as well. So, if we look at realizable pay separately for years one through three, the sum of those years' realizable pay amounts would equal the net realizable pay over the three-year period, i.e., if we calculated that gain all at once. In fact, any measure of "realizable pay" that does not satisfy that "sum-of-the-periods equals the net-for-the-period" constraint is not really economically valid, and would provide an inferior basis for comparing pay to performance.

Even an imprecise measure of realizable pay (because of the limits on LTI and other data) as outlined above would be a better than a measure of realized pay, which is highly dependent on dates that executives choose to exercise their options, and would be far better than any measure that of pay that conflates the target or grant-date values of certain compensation elements with the actual awards or realized gains of other compensation elements.

We recommend that ISS recognize the four-element calculation of realizable pay above, or some reasonable simplification of that methodology, as a valid basis for comparing pay to performance.

#### Feel Free to Contact

If you have any questions about either of these recommendations, please feel free to contact me at my email or telephone. I have been to your offices before to discuss compensation issues, and would be happy to do so again, if you are interested in the ideas set forth here.

Best regards,



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