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ISS Issues White Paper on Say on Pay "Pay for Performance" Test

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Institutional Shareholder Services, Inc. (ISS) published a white paper today[1] that describes the methodology pursuant to which ISS will, beginning February 1, 2012, implement its pay-for-performance test described in its U.S. Corporate Governance Policy 2012 Updates. The test is one of the primary methods by which ISS determines whether to recommend for or against a company's management say-on-pay (SOP) vote, with companies failing the test being deemed to have a "pay for performance disconnect."

In determining whether there is a "pay for performance disconnect" this proxy season, ISS will measure the degree of alignment between CEO pay and total shareholder return (TSR) within the subject company's peer group for a one- and three-year period, as well as the absolute alignment between CEO pay and the company's TSR over a five-year period. The white paper specifies that ISS will select 14 to 24 peer companies against which the subject company's TSR performance and CEO pay will be measured for the one- and three-year periods ending on the last day of the month closest to the subject company's fiscal-year end. Peer companies will be limited to those in the same two-digit GICS category as the subject company, each with annual revenues (or assets for financial companies) between 0.45x and 2.1x the subject company's revenues (or assets) and a market capitalization between 0.2x and 5x the subject company's market capitalization. This list of companies will then be filtered to 14 to 24 companies in the subject company's six-digit GICS category (or four- or two-digit category if fewer than 14 companies exist in the six-digit category), with companies "closest in size" (presumably based on market capitalization or assets) selected first and larger and smaller companies added to maintain the subject company at or near the median size of the list of peer companies. "Super-mega" non-financial companies (approximately 25 Russell 3000 companies each with greater than $50 billion in annual revenues and at least $30 billion in market capitalization) will collectively comprise a stand-alone peer group, and ISS will compare their respective one- and three-year TSR performance and CEO pay against the members of that group. In each case, annual revenues, assets and market capitalizations will be determined as of June 1 or December 1 (presumably the relevant year is the year prior to the year in which the proxy is definitively filed).

Now that the white paper has been released, companies can assess how their TSR performance and CEO pay will compare to that of their peers under ISS' test. Companies should use the criteria set forth in the white paper to determine whether they are likely to have a "pay for performance disconnect" based on these criteria, and, if so, what actions, if any, are advisable to take in light of this analysis. For a further discussion of ISS' pay-for-performance policy, see our memorandum of November 18, 2011, "ISS Updates Voting Policies for the 2012 Proxy Season." For a discussion of the actions a company may consider taking to help with its SOP vote, see our memorandum of November 9, 2011, "How to Win the Say on Pay Vote."

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[1] This memo was originally released on December 20, 2011.

