



## RADFORD ALERT

### Institutional Shareholder Services (ISS) Clarifies Its New Approach for Selecting Pay-for-Performance Peers

As many clients already know, Institutional Shareholder Services (ISS) is in the midst of altering its peer group selection practices ahead of the next round of CEO pay-for-performance assessments. To the delight of many companies, these changes include greater consideration of a company's self-selected compensation benchmarking peers. However, until earlier this week, very little was known about the new ISS selection process, particularly the steps ISS will actually take to incorporate client peer groups into its existing frameworks.

Fortunately, with the release of a new FAQ document on its peer group selection process, [available here](#), and a new peer group submission form for companies, [available here](#), clients can now gain a much fuller understanding of the revised ISS methodology.

To begin with, Radford recommends that clients **immediately** consider the implications of providing their CEO compensation benchmarking peer group to ISS, as the deadline for making submissions to ISS is "by" **December 21, 2012**. Although there are several potential benefits to submitting peers to ISS, clients are advised to study the new policies carefully before taking action.

#### Peer Group Submissions

Generally speaking, providing your benchmarking peers to ISS will allow ISS to generate a greater degree of alignment between its peer groups and your self-selected peers. This should be welcome news for many companies. According to an internal ISS analysis, ISS expects its new peer group approach to increase the prevalence of companies with at least a 50% overlap between ISS- and self-selected peers from approximately 20% in 2012 to 40% in 2013. Furthermore, the same ISS study suggests that its new peer group methodology should raise average overlap rates between ISS- and self-selected peer groups to above 40%. These rates of overlap may fall short for some companies, but they nevertheless represent a positive step forward. Finally, for companies with non-Russell 3000 peers, providing specific peer lists to ISS will allow ISS to expand its overall database coverage; thereby making future peer group development efforts more likely to align.

Thus, in broad strokes, the ability to submit CEO compensation benchmarking peers to ISS should represent a positive opportunity for many companies. Still, Radford highly recommends that its clients contact their respective account managers to discuss the appropriateness of providing peer groups to ISS by the December 21, 2012 deadline.

For example, companies with concerns over GICS groupings may want to consider different or additional lines of action, including contacting Standard & Poor's at 1-800-523-4534 if they believe they are misclassified in the GICS system.

Furthermore, clients with highly diverse peer groups or with peers ranging widely in size across various financial metrics may want to consider a more proactive outreach approach with ISS beyond the basic submission of a peer list. There is certainly a risk that ISS could view diverse or “aspirational” peers negatively.

In addition to the above considerations, clients should take careful note of the key items listed below before providing their peer group to ISS:

1. If you have not made, or do not intend to make, changes to your previously disclosed peer group, or do not wish to provide this information in advance to ISS, no action is required.
2. The peer group provided to ISS should be the peer group used for benchmarking CEO pay for FY 2012. (i.e., the peer group you most likely plan to disclose in your forthcoming proxy statement; peer groups recently developed for making FY 2013 CEO compensation decisions should not be provided.)
3. While public disclosure of peer group information is not required, the expectation is that peers provided to ISS will be disclosed in the upcoming proxy. (ISS states that its research team will use this information only for the purpose of constructing peer groups.)
4. Companies should avoid multiple submissions per company or provision of information other than relevant peers as described above.
5. Following the submission of peers to ISS, companies will receive further instructions via email regarding confirmation of the submitted list. Companies will be asked to provide an electronic copy of the submitted list on company letterhead.
6. Company peer groups must be submitted by December 21, 2012 in order to ensure consideration in ISS' peer group construction process for 2013.

## ISS Peer Group Methodology Changes

Once a decision is made on providing your FY 2012 CEO compensation benchmarking peer group to ISS, clients can shift gears toward understanding the specific mechanics of how ISS will better integrate company peer groups into its overall peer group framework.

According to the ISS FAQ document mentioned above, “the new peer group methodology maintains its focus on identifying companies that are reasonably similar to the subject company in terms of industry profile, size, and market capitalization.” At the most general level, this approach is no different than in past years. However, ISS has tweaked its methodology significantly in key sections, particularly with respect to its use of GICS classifications. According to ISS:

ISS' selected peer groups generally contain a minimum of 14 and maximum of 24 companies based on the following factors:

- > the GICS industry classification of the subject company
- > the GICS industry classifications of the company's disclosed benchmarking peers
- > size constraints for both revenue (or assets for certain financial companies) and market value

Subject to the size constraints, and while choosing companies that push the subject company's size closer to the median of the peer group, peers are selected from a potential peer universe in the following order:

- > from the subject's own 8-digit GICS group (**NEW**)
- > from the subject's peers' 8-digit GICS groups (**NEW**)
- > from the subject's 6-digit GICS group
- > from the subject's peers' 6-digit GICS groups (**NEW**)
- > from the subject's 4-digit GICS group

- > When choosing peers, priority is given to potential peers within the subject's "first-degree" peer group (the companies that are either in the subject's own peer group, or that have chosen the subject as a peer [commonly known as a "peers of peers" approach]), and companies with numerous connections (by choosing as a peer or being chosen as a peer) to these first-degree peers. All other considerations being equal, peers closer in size are preferred. **(NEW)**

As ISS has noted in several publications, the benefit of its revised approach is an expected improvement in the overall alignment of ISS- and company self-selected peers. The table below summarizes expected gains:

	New Methodology	Current Methodology
<b>GICS precision — 8-digit</b>	The average company has more than 80% of peer selections drawn from the company's 8-digit GICS group or the 8-digit GICS groups of self-selected peers	Only 40% of peers are drawn from the company's 8-digit GICS
<b>GICS precision — 2-digit</b>	No peer groups have members based on 2-digit GICS	12% of peer groups have members based on 2-digit GICS
<b>Similarity with company's selected peers</b>	42% of companies have a potential ISS peer group that overlaps at least 50% of their own  On average, an ISS peer group contains 44% of company's chosen peers	20% of companies have a potential ISS peer group that overlaps at least 50% of their own
<b>Size comparison</b>	Over 90% of peer groups maintain the subject company within 20% of the peer group median size by revenue	82% of peer groups maintain the subject company within 20% of the peer group median size by revenue

Nevertheless, clients should not necessarily assume that go-forward ISS peer groups will align more directly with their peer groups. ISS still reserves the right to use discretion and will likely adjust peer groups to avoid the inclusion of peers it views as outliers. Many of these issues are discussed in detail in the section below.

## Key Peer Group Issues

The ISS peer group methodology FAQ released earlier this week includes a total 26 separate items that companies are encouraged to explore in detail. However, several items jump out as critically important to understanding future ISS peer group decisions. For the benefit of our clients, we have reproduced the items that we feel are the most impactful below:

### 1. Will a company's self-selected peers always appear in the ISS peer group, if they meet ISS' size constraints?

No. While the new methodology does place a priority on the company's own peer selections, there are a number of reasons why a company-selected peer may not appear in the final ISS list, even if it meets the relevant size (revenue or assets and market capitalization) constraints.

As noted above, the new methodology also places priority on other factors as it builds the peer group:

- > The company's own 8-digit GICS category
- > Maintaining the subject company size at or near the median of its peer group
- > Maintaining the approximate distribution of GICS industry codes as reflected in the company's self-selected peer group

As a result, at times including a company's self-selected peer may push the subject company away from the median, or lead to an overrepresentation of that industry within the final peer group. In these cases the company's self-selected peer may not be included. In addition, if a company's self-selected peer is the only peer company in its 6- and 8-digit GICS category, it will receive a lower priority in the peer selection process.

## 2. What are ISS' size parameters for qualifying a potential peer?

ISS applies two size constraints to qualify potential peers:

- > **(NEW) Revenue** (or assets for certain financial companies, as noted below). In general companies should fall in the range 0.4 to 2.5 times the company's revenue (or assets). These ranges are expanded when the subject company's revenue is larger than \$10 billion or smaller than \$200 million in revenue (assets). Companies smaller than \$100 million in revenue or assets are treated as if they have \$100 million in revenue/assets.
- > **(NEW) Market capitalization**. Companies are classified into market capitalization buckets as follows (all values in millions)

Bucket	Low end	High end
Micro	\$0	\$200
Small	\$200	\$1,000
Mid	\$1,000	\$10,000
Large	\$10,000	No cap

A potential peer must have a market cap that falls between 0.25 times the low end and 4 times the high end of the subject's market capitalization bucket.

## 3. Does ISS apply manual judgment in the process of building peer groups?

Yes. ISS will review cases where the standard methodology appears to have produced inappropriate peers and may adjust peer groups in these cases. The basic principles of the methodology will apply: peers should come from similar industries and be of similar size, and company peers should be prioritized where possible.

## Next Steps

Radford highly recommends that its clients contact their respective account managers to discuss the appropriateness of providing peer groups to ISS by the December 21, 2012 deadline. For further reference materials on these important issues, the new ISS peer group methodology FAQ is [available here](#), and the new ISS peer group submission form is [available here](#).

For general consulting questions, please write to [consulting@radford.com](mailto:consulting@radford.com).

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