ISS Publishes FAQs on Peer Group Selection Methodology and Seeks Input from Issuers on Changes to Self-Selected Peer Groups

On December 4, 2012, ISS published a set of FAQs on its methodology for selecting the 14 to 24 member peer group that it will use to evaluate a company's executive compensation. The FAQs also address how companies can provide ISS with information about any changes to self-selected peer groups. The FAQs can be found by clicking here.

The FAQs note that ISS will select a company's peer group based on:

- the GICS industry classification of the subject company;
- the GICS industry classifications of the company's disclosed benchmarking peers[1]; and
- size constraints for both revenue (or assets for certain financial companies) and market value.

In selecting a company's peer group, ISS will choose first from the company's "first degree" peers, which ISS defines as companies that are either in the subject company's own peer group or that have chosen the subject company as a peer, as well as companies with numerous connections to these first-degree peers (by virtue of choosing such "first degree" peers as a peer or being chosen by such "first degree" peers as a peer). All other considerations being equal, ISS will seek to select peers that are closer in size to the subject company, generally based on revenues and market capitalization as discussed below. In addition, under the new methodology, peer group members will be selected based on the 8-, 6- or 4-digit GICS industry classification group of the subject company or its self-selected peers (with no peer group members being selected based on a 2-digit GICS group). While the new ISS methodology will prioritize a company's self-selected peers, the final ISS peer group list may not necessarily match the company's peer group due to ISS's balancing of both the number of peer group members in the company's 8-digit GICS category and the number of peer group members across the GICS industry codes represented in the company's self-selected peer group, as well as ISS's desire to place the company at or near the median size of its peer group.[2]

The FAQs provide details about size parameters for qualifying peers – generally revenue (or, where applicable to certain financial companies, assets) in the range of 0.4 times to 2.5 times the subject company's revenue (or assets) for company's with revenue (or assets) between $200 million and $10 billion (with an expanded but undefined range for a company that falls above or below those amounts) and market capitalization of between 0.25 times the low end and 4.0 times the high end of the subject company's applicable market capitalization bucket (micro, small, mid or large). In addition, the FAQs provide guidance on:

- how ISS will determine the number of members of a company's peer group;
- the treatment of a company's foreign-domiciled and privately-held self-selected peers;

[1] Where a company uses multiple peer groups for benchmarking ISS will focus on the peer group used to benchmark the CEO's pay.
[2] ISS also noted that the peer group used to benchmark executive pay is different from the peer group used by ISS to calculate a company's allowable cap on an equity plan proposal, with the latter being based on industry, as adjusted for market cap size.

- the elimination of the "supermega" peer group for larger "super-megacap" companies; and
- ISS's methodology for calculating peer medians for purposes of the Components of Pay table.

ISS indicated that, based on back-testing, its revised peer group selection methodology resulted in a change of less than 15 points (up or down) in the Relative Degree of Alignment (RDA) measure for more than 80% of companies and a change of less than 0.2 in the Multiple of Median (MOM) measure for 80% of companies, resulting in the same quantitative screen concern levels for more than 95% of companies.

ISS will construct peer groups under the updated methodology in early January for stockholder meetings on or after February 1 and again in July and August, after the Russell 3000 index is updated in July, for use after September 1. As detailed in the FAQs, ISS is this year giving companies an opportunity to update their self-selected peer groups for benchmarking CEO pay if they have changed since the 2012 proxy statement disclosures. While the opportunity to provide updated information is purely voluntary, any company that wishes to inform ISS of a change in its self-selected peer group should complete the notification form (which can be found here) by December 21, 2012 in order to ensure that the updated information is used by ISS in its consideration of the company's peer group construction for 2013. A company may use this as an opportunity to identify changes in its peer group resulting from significant business changes, mergers, spinoffs or bankruptcies of previously disclosed peer group companies. While ISS expects that companies will provide the peer group used for pay decisions in 2012, if a company anticipates changes to its peer group in 2013 due to these types of significant business changes making companies in the 2012 peer group no longer relevant, a company can provide such additional information to ISS as part of its peer group notification form. The list provided to ISS need not be publicly disclosed at the time it is provided to ISS but should match the disclosure to be included in the company's 2013 proxy statement (and any differences between the two could result in additional scrutiny from ISS as part of ISS's pay for performance analysis). A company can also include in the feedback form information about market indices or benchmarking surveys that are used by the company for benchmarking purposes, although ISS will not directly use the information in its peer selection process.

While the additional information detailed in the FAQs regarding ISS's peer group selection methodology (and the opportunity to provide ISS with updated information as a source of input into the ISS process) may enable companies to fine tune their peer groups, the updated ISS methodology is unlikely to result in a significant number of changed recommendations from those that would have resulted under the prior methodology.