ISS Proposes Executive Pay Disclosure Best Practices

ISS Governance Services, the proxy advisory arm of RiskMetrics Group (which acquired the former Institutional Shareholder Services in January) has proposed a set of "best practices" for companies to follow when complying with the SEC's new executive compensation disclosure rules. The recommendations are contained in the first of two reports to be issued this fall by ISS that critique the disclosures from the 2007 proxy season.

The eponymous report, "Proposed Best Practices in Executive Compensation Disclosure," contains the firm's initial reaction to the first set of disclosures under the new rules and offers a series of "best practices" designed to facilitate clearer, more meaningful information about corporate executive compensation practices. As the report makes clear, the proposals are intended to stimulate thought and discussion about both the form and content of compensation disclosure, ultimately leading to better pay practices, better corporate performance, and better stock returns. The second report, entitled "Compensation Disclosure: Best Practices and Examples," will illustrate the proposals with specific examples taken from proxy statements filed earlier this year.

Overview of Report

The ISS report addresses three broad areas: the style and readability of the disclosure presentation, its content, and the need to connect the various pay elements into a comprehensive picture of the overall compensation program. Like the report of the Staff of the SEC's Division of Corporation Finance, the content discussion focuses largely on the Compensation Discussion and Analysis, the de facto centerpiece of the new disclosure where companies are to explain how and why they implemented their executive compensation programs and reached their specific pay decisions for the year. Nonetheless, the report is also helpful in clarifying ISS" views on how companies should approach the required tabular disclosure and the accompanying narrative discussions.

Style and Readability

The report echoes the SEC's message that, in many ways, the presentation of executive compensation disclosure is as important as its content. To make the information more accessible to investors, ISS proposes six "best practices":

- Write for the intended audience (which is defined to include investors, investment analysts and the proxy advisory firms, executives and directors, and the business and financial media)
- Write in plain English, using strong (that is, detailed and incisive) content
- Start with an executive summary (presumably for the CD&A, but possible for the entire compensation section of the proxy statement)
- Lead readers through the report with a well-developed set of titles and subtitles
- Emphasize visual formatting, using tables, charts, bullet lists, and other techniques (for example, text boxes and color) to convey substantive content in a meaningful way
- Eliminate technical jargon, use illustrations, and, when necessary, enhance the required tables to make discussion easy to follow

Although each of these proposals makes sense, for many technology companies—constrained by limited resources and time—they are likely to take a back seat to the primary objective: getting the content right. In

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addition, given the relative simplicity of their executive compensation programs, it may not be necessary to employ many of these practices to still produce clear and effective disclosure.

Content

The report reminds companies that compensation disclosure, particularly the CD&A, should explain the connection between a company's business strategy and its executive compensation program. To meet this objective, ISS proposes five "best practices" in drafting the Compensation Discussion and Analysis:

- Tell the company's unique story
- Explain the roles of management and any compensation consultant in the pay-setting process
- Explain the compensation mix and why it was selected
- Address the five key aspects of every performance-based compensation arrangement: the performance measures, the quantitative and qualitative targets, target pay levels, any peer groups used, and actual performance and payouts
    - When discussing performance metrics, define the measures and targets, explain why the metrics were selected, clarify the degree of difficulty of attaining the targets, and put the targets into context
    - When discussing peer groups, identify the companies and explain why they were selected (disclosing selection criteria and quantitative comparisons of key features)
    - If relevant, how (and why) discretion was exercised to change award targets and payouts
- When evaluating CEO performance, explain how his or her actual accomplishments compared to his or her pre-established objectives for the year

For most technology companies, the challenges presented in drafting next year's CD&A will continue to center on accurately communicating the CEO's involvement/influence over the pay-setting process and explaining how annual incentives and long-term equity awards are determined. Implicit in the ISS proposals on performance-based pay is an assumption that pay decisions can be described linearly, using a largely formulaic explanation. Where compensation committees use their business judgment to set bonus payouts and equity award levels, however, explaining the deliberations that led to a specific pay result will be neither easy nor straightforward.

The Total Picture

Recognizing that a pay program is more than just the sum of its discrete elements, the report reminds companies to relate these discussions back to the overarching purpose of executive compensation —to drive the company's business goals. To this end, ISS suggests that a comprehensive CD&A will answer the following questions:

- How do the metrics underlying performance-based compensation advance the company's strategy?
- What is the significance of the quantitative targets in view of the company's business environment? How do these targets compare to past performance, company and industry trends, and future expectations?
- How did the company's strategy and compensation philosophy shape the pay mix?
- What roles did the CEO and compensation consultants play in the pay-setting process?
- How do actual performance and payouts compare to the pre-established goals and targets? What if any adjustments were made, and why?

Given the role that performance-based compensation plays in most executive compensation programs, this emphasis on a holistic presentation is really just another way of emphasizing investors' interest in understanding whether these arrangements are serving their stated purpose. Performance linkage of individual pay

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plans out of a legitimate concern of micromanagement by overzealous investors. In our view, this will continue to be the most challenging—and controversial—aspect of these compensation analyses in the years ahead.

Final Thoughts

While much of the ISS report mirrors the themes of the SEC Staff report, it remains to be seen whether RiskMetrics intends to be as flexible as the Commission in judging companies' initial disclosure efforts. In recent years, a company's governance and compensation disclosure has become an increasingly significant factor in ISS' voting recommendations on director nominees and compensation-related proposals. Until it issues its corporate governance policy updates later this fall, it's unclear to what extent the quality of a company's executive compensation disclosure will influence these recommendations. This will be a key issue for technology companies, whose institutional shareholders tend to closely follow ISS' voting recommendations. For now, ISS has initiated what it clearly hopes will be a constructive dialogue with the corporate and investor communities on how best to use the SEC's new disclosure framework to make executive pay programs more effective. ◆

To obtain a copy of the RiskMetrics' report "Proposed Best Practices in Executive Compensation Disclosure," click here.

About Compensia

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management. Formed in 2003 by a group of leading executive compensation experts with more than 60 years of experience, our mission is to offer Thoughtful Pay™ solutions in an ever-changing executive compensation landscape.

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