Shoot the Arrow, Then Paint the Target:
CEO Compensation and ISS Benchmarking

Internet Appendix

IA1 Example of Focal Firm's Intervention to Influence Turnover in ISS Peers

In this appendix, we present anecdotal evidence of focal firms' intervention in persuading ISS to revise the ISS Peer group. The case in point refers to the communication between Ms. Roxanne S. Austin, Chair of the Compensation Committee, Abbot Laboratories Board of Directors, Institutional Shareholder Services (ISS), and Abbot Laboratories' shareholders.[1]

The letter to the ISS Team deals with several issues, one of which is ISS' selection of peers for its relative degree of alignment (RDA) test.[2] Prior to the filing of Abbott Lab's 2018 proxy statement, Ms. Roxanne Austin strongly criticized ISS for having chosen an inappropriate peer group that classified Abbot's degree of alignment as a cause for more concern than was

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[1] See pages 4 and 5 of the Proxy Statement filed by Abbot Laboratories

(https://www.sec.gov/Archives/edgar/data/1800/000110465918022657/a18-9600_1defa14a.htm).

[2] The internet Appendix contains a description of the criteria used by ISS in selecting their peer group. Although it does not explicitly state that ISS uses the results from an RDA test to make changes to their peer group, it is conceivable that ISS may revise its peer group composition in recognition of focal firms' prior total stock return (TSR) performance.

appropriate. The basis for the complaint regarding the composition of the peer group relates to the formal ISS parameters - firm size and complexity. To quote, "**ISS has produced a misleading view of the alignment between Abbott's relative pay and performance by comparing Abbott to peers which do not adequately reflect Abbott's increased size, scope, and complexity"**. The letter argues that the composition of the peer group is inappropriate because its members have low compensation and high performance relative to the actual peers.[3]

IA2 ISS Methodology in Selecting Peers

The ISS Proxy Advisor's methodology focuses on selecting peers that are similar to the focal company in terms of industry profile, size, and market capitalization (see https://www.issgovernance.com/company-peer-group-feedback/). The financial data to measure these characteristics are obtained from Standard and Poor's COMPUSTAT on a twelve-month trailing basis as of December 1 for annual meetings between February 1 and September 15, and as of June 1 for annual meetings between September 16 and January 31.

Industry: ISS uses a sequence of filters based on the industry to which the focal firm belongs. Specifically, keeping the size close to the focal firm's size, peers are chosen in the following order: from the focal firm's 8-digit GICS group, followed successively by the 6-digit and 4-digit GICS groups.

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[3] For other examples of disputes between focal firms and ISS please see https://www.davispolk.com/insights/client-update/early-examples-companies-disputing-iss-say-pay-recommendations, and the post titled 'Who Should Investors Believe When it Comes to Peer Groups?' on May 14, 2011, by Robin Ferracone, Executive Chair of Farient Advisors LLC. (https://www.forbes.com/sites/robinferracone/2011/05/24/who-should-investors-believe-when-it-comes-to-peer-groups/#617d5def42f1)

Size: ISS measure size based on revenue and market capitalization. As a rule of thumb, firms with revenues in the range 40% to 250% of the focal firm's revenue (or assets) qualify to be in the pool of peer firms. ISS uses discretion and adjusts the range depending on the size of the focal firm.

Market Capitalization: Focal firms are classified into micro (0 to $200m), small ($200m to $1000m), mid ($1000m to $10,000m) and large ($10,000m and above) categories. A potential peer must have a market capitalization between 25% of the low end and up to 400% of the high end of the focal firm's classification.

It should be noted that these formal criteria apply to the admissibility into the set of potential ISS Peers. ISS may still have flexibility in selecting its peers from that set. Furthermore, the number of potential ISS Peers is likely to be negatively related to the size of the focal firm. Thus, the flexibility of ISS in selecting its peers may also be negatively related to focal firm size.

In addition to the formal criteria mentioned above, ISS takes account of the Actual Peers. ISS also reviews the Compensation Discussion and Analysis (CD&A) section of focal firms' proxy statements and applies relative and absolute quantitative tests to determine the degree of alignment between pay and performance. As part of the relative tests, ISS peer groups serve as benchmarks against which focal firms' past two to three-year total stock return (TSR) performance is compared (referred to as a relative degree of alignment, or an RDA, test). If a focal firm does not meet a pre-determined threshold of performance, the quantitative screen is then followed up with an in-depth qualitative assessment that forms the proxy advisor's

recommendation to institutional clients.[4] These reviews mean that ISS has some flexibility of choosing its peers from the admissible set.

IA3 Computation of Excess Compensation of Focal Firms' CEOs

This appendix presents the methodology employed to compute excess compensation of focal firms' CEOs, scaled by total assets. We estimate the relation between CEO compensation and firm characteristics, CEO characteristics, and governance variables. The dependent variable is the logarithm of the focal firm's total CEO compensation, winsorized at the 1st and 99th percentiles. The explanatory variables are based on those identified in prior literature (Core, Holthausen, and Larcker (1999)) We include one-year lagged values of log assets ($ASSET_{t-1}$), capital expenditure ($CAPEX_{t-1}$), leverage ($LEVERAGE_{t-1}$), advertising ($Advertising_{t-1}$), and market-to-book ($MKBK_{t-1}$) (see Smith and Watts,1992; and Lewellen, Loderer, and Martin (1987)). To capture the impact of performance, we include one-year lagged and concurrent values of stock returns (Stockret and $Stockret_{t-1}$) and return on assets (ROA, and ROA_{t-1}). We control for risk using stock return volatility measured over the previous year (STDSTOCKRET). Variables that measure the impact of CEO characteristics include DUALITY (i.e., an indicator variable that equals one when the CEO is also the chair of the board), and TENURE. The logarithm of number of institutional owners of the focal firm (ln(NUM_INST_OWNERS)) proxies for institutional ownership. The latter two variables may (in the regressions that are reported below) control for ownership structure because institutional ownership has been shown to affect executive compensation See Hartzell and Starks (2003)). We control for year and CEO

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[4] See https://www.issgovernance.com/file/policy/active/americas/Pay-for-Performance-Mechanics.pdf

× Firm fixed effects with robust standard errors clustered at the firm level. We report *t*-values where ***, **, and * indicate, respectively, 1%, 5% and 10% levels of significance. Appendix-B (in the published manuscript) contains the variable definitions. The following table (Table IA-1) reports the regression estimates.

Table IA-1: Results from the regression estimating the focal firms' CEO total compensation. We include contemporaneous and lagged ROA and STOCKRET as explanatory variables. Lagged explanatory variables are indicated by a *t-1* subscript**.**

VARIABLES	ln(CEO_TC)
ASSETS $_{t-1}$	0.317***
	(6.898)
CAPEX $_{t-1}$	0.522
	(1.317)
LEVERAGE $_{t-1}$	-0.514***
	(-3.710)
ADVERTISING $_{t-1}$	-0.038
	(-0.033)
MKBK $_{t-1}$	0.008**
	(2.202)
STOCKRET	-0.007
	(-0.278)
STOCKRET $_{t-1}$	0.033
	(1.391)
ROA	-0.022
	(-0.159)
ROA $_{t-1}$	0.156
	(0.875)

STDSTOCKRET	0.072
	(0.274)
DUALITY	0.023
	(0.730)
TENURE	0.054*
	(1.902)
TENURE_MISSING_INDICATOR	0.882*
	(1.946)
ln(NUM_INST_OWNERS)	0.041
	(1.550)
INTERCEPT	11.917***
	(23.116)
Year FE	Yes
Firm×CEO	Yes
Industry FE	No
Observations	5,571
R-squared	0.901
Adj	0.846

We use the estimated coefficients from the above regression and calculate the predicted value of the log CEO total compensation while removing the impact of the fixed effects (denoted as PRED). We do this to control for any performance impact that is directly due to CEOs' excess compensation. The dollar value of PREDICTED_COMP is given as:

(AE_1) $$\text{PREDICTED\_COMP} = e^{PRED}$$

We use the dollar value of the predicted CEO TC from equation AE_1 to compute the dollar value of excess compensation (in AE_2) and denote it as RESID_COMP:

(AE_2) $$\text{RESID\_COMP} = e^{(\ln(\text{CEO\_TC})} - \text{PREDICTED\_COMP}$$

To obtain a proxy of the potential impact of this excess compensation on firms' ROAs we divide RESID_COMP in AE_2 by total assets. This measure is denoted as EXCESS_COMPENSATION:

(AE_3) $$\text{EXCESS\_COMPENSATION} = \frac{\text{RESID\_COMP}}{e^{(\ln(\text{ASSETS})}}$$

The value of EXCESS_COMPENSATION given in AE_3 is divided by $1,000,000 and employed as a control variable in the performance regression in Table 6.