October 9, 2012

VIA EMAIL

Dr. Martha Carter
Chair
Global Policy Board
Institutional Shareholder Services, Inc.
2099 Gaither Road
Rockville, MD 20850-4045

RE: Center On Executive Compensation Comments in Response to 2013 Draft ISS Policy Changes

Dear Dr. Carter:

The Center On Executive Compensation ("Center") is pleased to submit its comments on Institutional Shareholder Services, Inc.'s ("ISS") 2013 draft policies on behalf of its Subscribers. As you know, the Center is a research and advocacy organization that seeks to provide a principles-based approach to executive compensation policy from the perspective of the senior human resource officers of leading companies. The Center is a division of HR Policy Association, which represents the chief human resource officers of over 330 large companies, and the Center's more than 100 subscribing companies are HR Policy members that represent a broad cross-section of industries. Because senior human resource officers play an important role in supporting the compensation committee, we believe that our Subscribers' views are particularly helpful in better understanding how executive compensation plans are developed and executed.

Consistent with the Center's mission, our comments are focused on ISS's policy changes regarding executive compensation and related governance issues.

A. Changes to Peer Group Selection Methodology

In its proposed 2013 policies, ISS indicated that it is considering the following changes to its approach to peer group selection:

1. Focus initially on subject company's 8-digit GICS groups in order to identify more closely related peers;
2. Draw peers from GICS groups of the subject company's self-selected peers, rather than just the company's own GICS code;
3. Refine the selection of peers by size to maintain more than 90% of companies within 20% of the peer group median;
4. Prioritize the selection of peers that are in the subject company's peer group and that have chosen the subject company as a peer.

The Center applauds ISS's effort to include companies' selected peers in the peer group selection process, but we are concerned that the proposed methodology attempts to address the significant problems with the existing GICS-based methodology by expanding the use of GICS groups (*i.e.*, looking at peers in the GICS groups of company-selected peers that are in a different group in addition to the GICS group of the subject company). This solution compounds the flaws of a GICS-based method rather than cures them. The past two years of say on pay have shown that reliance on GICS codes to determine peers has yielded increasingly illogical groups of peer companies, as evidenced by the large proportion (24 out of 41 as of September) of S&P 500 companies who filed supplemental information with the SEC referencing an inappropriate peer group selected by ISS. We have heard from large institutional investors who have also questioned the effectiveness of ISS's GICS-based methodology and have in some cases sought to develop their own peer groups (based on those used by their investment analysts) as an alternative.

Peer group selection is the foundation of the relative alignment test in ISS's pay for performance analysis. As ISS indicated in its 2011 white paper on the subject, peer comparisons apply to two out of the three quantitative tests, and a high concern on any one test triggers a high concern for the overall quantitative test.[1] Thus, it is imperative that if ISS is going to change its peer group analysis, it should do so in a manner that will more clearly reflect companies that are true peers of the subject company with regard to primary factors like size, industry and the market for talent.

Several of our Subscribers have indicated that ISS's proposed policy to use 8-digit GICS groups sounds good on its face, but that it will not be possible to construct a peer group solely from existing 8-digit, 6-digit or even 4-digit GICS groups within ISS's proposed size range. Thus, it is highly doubtful that the proposed change, despite its apparent focus on industry and size, will improve the accuracy of peer group selection for many companies.

The Center and its Subscribers continue to believe that the compensation committee is best positioned to assess which companies should be included in its peer group. We understand that investors may expect ISS to conduct an evaluation of company peer groups to determine overall appropriateness. To this end, the Center reiterates that ISS should use the company peer group as the foundation for its analysis and then screen the peer companies for size to determine if that peer group is reasonable.

Specifically, the Center recommends that ISS should review the company-chosen peer group to ensure that it maintains the subject company within a reasonable range of the median of the peer group based on size. If this is not the case, and in the event certain companies are not found to be reasonable peers even after review of the company's rationale for selecting them, those companies would be removed. Other companies would then be substituted based on size and/or industry, with industry preferably being determined based on obvious competitors and as identified by investment analysts when comparing financial performance within a sector. Alternatively in this scenario, if the removal of inappropriate peers results in a peer group which is too small, ISS could add to the company's peer group additional peers based on the GICS groups of the subject company and its peers, maintaining a reasonable balance of size of

[1] At the core of the new quantitative methodology are three measures of alignment between executive pay and company performance: two relative measures where a company's pay-for-performance alignment is evaluated in reference to a group of comparable companies, and one absolute measure, where alignment is evaluated independently of other companies' performance. ISS, *Evaluating Pay for Performance*, at 6.

comparators and a proportion of the industries represented in the ISS-chosen peer group to the industries represented by the company's chosen peers. It is important to note that when screening for size, ISS should evaluate whether the company already size-adjusts based on the revenue (or assets in the case of financial services firms) and market capitalization of the peer company when making pay comparisons to its peer group companies.

B. Addition of Realizable Pay to Qualitative Pay for Performance Evaluation

ISS has indicated that it is considering adding a comparison of realizable pay to grant date pay to supplement its qualitative evaluation of pay-for-performance alignment for large cap companies. The draft policy indicates that realizable pay would be defined as: "the sum of relevant cash and equity-based grants and awards made during a specified performance period being measured, based on equity award values for actual earned awards, or target values for ongoing awards, calculated using the stock price at the end of the performance measurement period."

The Center is encouraged by ISS's response to requests by both issuers and investors to consider alternate measures of pay which reflect the way pay programs actually operate based on company performance. However, based on feedback from its Subscribers, the Center continues to believe that a realized pay approach, which assesses whether pay actually realized is aligned with the performance which drove it, gives the clearest explanation of the link between pay and performance. As we stated in our response to the ISS 2013 policy survey in August, realized pay avoids the "apples to oranges" analysis of combining actual and future potential pay in addition to providing clearer line of sight on alignment of actual pay and actual results.

In addition, a realized pay approach remedies the disconnect that currently exists under ISS's relative alignment tests, in which TSR at the end of the fiscal year is compared to pay granted (in most cases) within the first quarter of the fiscal year, before the compensation committee could have been aware of what performance for that fiscal year would be. Since realized pay reflects the pay that was actually earned by the executive for the fiscal year, it is a more logical point of comparison for year-end TSR.

In the event that ISS decides to pursue a realizable pay analysis as part of its qualitative assessment, rather than a realized pay approach, the Center believes it is important that ISS clearly articulate what the goal of such an analysis would be. A comparison of realizable pay to grant date pay is not particularly meaningful, because realizable pay is a performance-dependent measure of pay which shows how actual and potential pay fluctuate with stock price as compared to the static grant date measure of pay. A more effective approach would be comparing the change in realizable pay to the change in company performance (*i.e.*, TSR) over a five-year period. This would align with the time period used in the absolute alignment test under ISS's quantitative pay for performance tests and would also enable shareholders to see how well pay plans are aligned with shareholder interests over time.

C. Pledging of Shares

Recognizing there have been a small number of cases of abuse that have been widely publicized, pledging of shares has many legitimate purposes which are beneficial to the company and the executive (such as supporting charitable and philanthropic giving). ISS has proposed to add pledging of company shares by directors and executives to its existing list of problematic pay practices which may result in a negative vote recommendation on say on pay. ISS presents a number of reasons for this, including that pledging of stock may lead to a forced sale of stock or be utilized as part of a hedging strategy. ISS bases its argument on the fact that pledging of shares could impact a significant percentage of the market value of the company. However, in looking at the 450 companies out of the Russell 3000 noted in the ISS proposal, the median executive pledging shares encumbered zero percent of market value. In other words, pledging does not appear to be a widespread occurrence or have a significant negative impact on market value, and making it a problematic pay practice that could lead to a negative say on pay vote appears to be excessive given the scope and impact of the practice. Given that senior executives typically have substantial share ownership in their companies, it is difficult to see how prohibiting the pledging of shares entirely would prevent executives or directors from selling their shares in most circumstances with the same result. In addition, there is a distinction between existing pledging arrangements by founders of shares which were not specifically compensation-related and the pledging of compensation-acquired shares by executives or directors.

The Center recommends that if ISS is going to make the pledging of shares a problematic pay practice, ISS should clearly distinguish between hedging and pledging and frame its pledging policy around a set of principles, such as the following:

- Executives and directors may not pledge unvested shares that are part of an ongoing incentive award;
- Executives and directors may not pledge shares that would put them in violation of the company’s stock ownership guidelines and/or retention requirements; and
- Executives and directors may not pledge shares that exceed a certain threshold of market capitalization.

The framework above places pledging in the appropriate context: it maintains the alignment of executive and director interests with those of shareholders while also recognizing that the executives and directors own the shares outright and may designate them as they wish, within reason.

D. Expanded Policy on Golden Parachute Proposals

ISS is proposing to consider existing change-in-control arrangements along with new or extended ones when evaluating the amount and structure of say on golden parachute proposals. Specifically, if existing change-in-control agreements have multiple problematic features, ISS will factor those features into its say on golden parachute vote. Since this change in policy is likely to result in increased negative vote recommendations, and will put companies currently in the process of a change in control at a disadvantage, a phase-in period should be considered. Also, it is not clear what standards ISS will use to determine whether potential golden parachute payments are “excessive” either on an absolute basis or as a percentage of transaction equity. ISS should explicitly include in its policy that the analysis of existing change-in-control agreements will be based on a qualitative and contextual review.

E. Environmental and Social Non-Financial Performance Compensation-Related Proposals

ISS is proposing to change its policy on shareholder proposals to link executive compensation to sustainability or social performance based on non-financial criteria from generally recommending against these proposals to making recommendations on a case-by-case basis. ISS has indicated it will consider a number of factors such as whether a company has a history of violations, whether it already has mechanisms and disclosure in place regarding social/environmental issues, and industry practice. The Center believes that the body most appropriate to evaluate these proposals is the compensation committee in consultation with the board as a whole. They are in the best position to evaluate whether the company should respond to or oppose a resolution. Unlike financial metrics, the evaluation and decisions around incorporating social and environmental achievement into compensation plans is linked to company strategy. Therefore, the Center believes that the decision to use sustainability-related metrics, and the evaluation of metrics in general for alignment with company strategy and shareholder interests, should be left to the judgment of the compensation committee.

F. Board Response to Majority-Supported Shareholder Proposals

ISS has proposed to change its policy to recommend against or to withhold votes from directors (except for new directors) if the board "fails to act" on a shareholder proposal that received a majority of the votes cast on the proposal. The Center believes that the purpose of nonbinding shareholder resolutions is to allow shareholders the opportunity to express their views on certain governance matters. It is up to the board to determine whether to implement the proposal, to take a different action or to take no action.

ISS's proposed policy seeks to turn a nonbinding resolution into a binding one, even if a substantial percentage of shareholders did not vote at all. This is inconsistent with current law and also inconsistent with public policy. Even the nonbinding say on pay requirement in Dodd Frank explicitly stated that a say on pay resolution may "not be binding on the issuer or the board of directors of an issuer, and may not be construed as overruling a decision by such issuer or board of directors" nor may it create or imply changes to the fiduciary duties of the board. The Center opposes this change because it has the effect of making a nonbinding resolution akin to a binding one and because the Center believes the board should be responsible for making the determination of whether implementation of a shareholder resolution is in the best interests of the company. This decision should be made without the further threat of a negative recommendation in the next proxy season.

Conclusion

The Center On Executive Compensation appreciates the opportunity to submit its views on the 2012-2013 policy process and welcomes the chance to provide the corporate perspective on ISS's policies. Please do not hesitate to contact me at tbartl@execcomp.org or 202-789-8692, if you have any questions about our comments would like to discuss them further.

Sincerely,

Timothy J. Bartl
President