Meridian Compensation Partners, LLC Comments on ISS Proposed Policy Updates

Meridian Compensation Partners, LLC ("Meridian") is pleased to provide the following comments to Institutional Shareholder Services, Inc. on ISS' proposed Policy Updates for 2012.

Meridian is one of the largest independent executive compensation consulting firms in North America. We provide trusted counsel to Boards and Management at hundreds of large public and private companies, consulting on executive compensation design issues, corporate governance matters and related disclosures. Our consultants have decades of experience in developing pay solutions that are responsive to shareholders, reflect good governance and align with company performance.

We strongly support ISS' emphasis on performance-based pay and on the need for executive compensation to correlate to company performance. We applaud ISS' approach to regularly examine its policies around pay for performance (as well as other matters), to survey the views of institutional shareholders, issuers, and advisors on significant compensation and governance matters and to solicit comments regarding proposed changes to its policies.

We have comments with regard to two of ISS' proposed policy updates: (i) board response to management say on pay proposals and (ii) evaluation of executive pay. The first proposed policy update logically fills a gap in ISS proxy voting polices brought about by the advent of mandatory say on pay votes. The second proposed policy update, with certain modifications, could represent a reasonable approach to evaluating CEO compensation. Our comments below stress nuanced refinements intended to enhance the clarity of these policy updates and to provide companies clear guidance on how to interpret and apply these updates.

ISS Proposed Policy Update: Board Response to Management Say on Pay (MSOP) Vote Outcomes

Meridian Comment: Meridian recommends that where a company's MSOP proposal received less than 50% support from shares actually voted at **two consecutive annual meetings**, a company should then be expected to provide an explicit response to such low shareholder support. Given that most compensation design decisions are made during the first half of a company's fiscal year, it is impractical to hold companies accountable based on a single shareholder vote on Say on Pay (SOP) that occurred during such fiscal year and may have taken into account performance that took place after the compensation decisions were made.

If ISS should ultimately require accountability by companies after a single MSOP shareholder vote, then we recommend that ISS adopt a precise definition for "significant opposition" prior to the start of the 2012 proxy season. We suggest "significant opposition" be set at a 40% level on shares actually voted.

Evaluation of Executive Pay (Applicable to MSOP Proposals)

Meridian Comment: Meridian has the following comments with regard to ISS' proposed new methodology to evaluate CEO pay-for-performance alignment.

- **Relative Alignment**. We have the following observations and recommendations regarding the new "relative alignment" test.

  — **Size of peer group**. We believe the change to a 14- to 24-company peer group is more appropriate than the current approach. However, see our comments regarding peer group transparency, below.

  — **Peer group development**. Under the "relative alignment test," ISS would move from a relatively objective method to a subjective method for developing a company's peer group. Without further guidance from ISS, it is not possible to determine whether the proposed method would yield peer groups that are better aligned with subject companies than under the current method. In that regard, we recommend ISS refine its proposed peer group selection process in the following manner:

    - **Industry**. Peer companies generally should be selected from the subject company's **8-digit GICS sub-industry code,** and broadened to 6 or 4 digits only if the initial approach results in an insufficient number of peer companies. In contrast to the 4-digit GICS industry group that ISS currently uses to develop peer group total shareholder return (TSR) statistics, this would yield peer companies that better relate to company's industry and business operations.

    - **Revenue**. Consistent with the approach used by many compensation committees, we recommend that ISS generally select peer group companies with revenues that fall within a range of one-third to three times the revenues of the subject company, with the median revenues ideally within 20% of the subject company's revenues.

    - **Market capitalization/life cycle maturity phase**. As a general matter, executive pay levels bear less of a direct relationship to a company's market capitalization, which tends to be **more** volatile and may or may not be representative of life cycle maturity phase, than it does company revenue (or assets, in the case of certain financial services firms, such as banks). However, we do recognize in certain instances market capitalization may be more correlative to pay levels than a company's revenues. We recommend that where revenues/assets provide the strongest correlation to pay, market capitalization should be used only as a secondary factor to evaluate the suitability of companies for inclusion in the peer group. For example, if after selecting a peer group using revenue criteria, ISS finds that the market capitalization of the issuer is well above that of the peer group, ISS should consider adjusting the peer group using market capitalization as the primary size criteria.

  — **Peer group transparency**. Under ISS current rules, an issuer has the ability to independently replicate its ISS peer group and run ISS pay-for-performance TSR tests. Due to the subjective nature of the proposed peer group methodology, it appears a company would be unable to **independently** replicate its ISS peer group (even with the above suggested refinements). This will deny companies the opportunity to evaluate their CEO pay for performance under the proposed relative alignment test. Accordingly, we believe that **ISS should instead have a formulaic process for determining peer groups** that each company can use to identify its own as early in the year as possible.

— **Comparing company's TSR peer group rank to CEO total pay peer group rank**. The validity of ISS proposed comparison of CEO pay rank to company TSR rank will turn on the method ISS uses to determine CEO total pay.

Under current policy, ISS determines CEO total pay, in part, based on the prospective values of equity grants made to the CEO that may or may not materialize. As a general matter, however, large public companies size annual equity grants (i.e., pay *opportunities)* based on competitive market practices and pay objectives, not on historical performance. For the same reason, annual changes to pay *opportunities* also tie more to market practice than to a company's prior performance. If ISS uses its current approach for determining CEO total pay, CEO equity grants (that have not yet been realized) would be measured against a company's historical financial performance.

The critical point is that performance-based compensation is forward looking in nature. Once granted, companies' financial and stock performance generally drives the ultimate realized value of equity compensation. Thus, for most companies, while CEO pay opportunities may show little correlation to TSR rank, total *realized* CEO pay will likely bear a significant relationship to the company's TSR rank. Therefore, we believe it is more appropriate to measure realized pay rather than prospective pay values against a company's TSR rank. This approach is consistent with the fundamental notions of pay for performance.

- **Absolute Alignment**. We have the following observations and recommendations regarding the "absolute alignment" test.

— **Determination of "strong" versus "weak" alignment**. According to the proposed policy updates, companies that demonstrate strong or satisfactory pay alignment will generally receive a positive recommendation (in the absence of other pay-related issues), while companies demonstrating weak alignment will require further qualitative review to determine ISS final vote recommendation. To provide transparency regarding this part of the "alignment" test, we recommend that ISS provide clear guidance as to under what circumstances a company would demonstrate "strong" or "weak" alignment. Since the alignment test is intended to measure the relationship between changes in pay versus changes in TSR, ISS policy guidelines should provide the point or range of correlation coefficients that demonstrate either strong or weak alignment.

— **Qualitative factors**. Under the proposed Policy Updates, ISS will perform a qualitative analysis of pay programs of companies that show weak alignment. We believe that some of these qualitative factors are problematic (or need additional guidance) for the reasons stated below:

  - **Ratio of performance- to time-based equity awards**. We recommend that ISS provide specific guidance as to when a company would meet or fail the performance-based equity ratio test.

  - **Overall ratio of performance-based compensation**. We recommend that ISS provide guidance as to when a company would meet or fail the overall performance-based ratio test.

  - **The robustness of disclosure and rigor of performance goals**. The "rigor of performance goals" factor we find especially problematic. No reasonable standard exists against which to evaluate the "rigor" of a company's performance goals. No definition exists as to what constitutes a rigorous performance goal. Performance goals are unique to each company and are based, in part, on proprietary and confidential business strategies and tactics that are not accessible by ISS. Goal setting is a dynamic process and one where informed business judgments need to be made by both senior management and the board on a regular basis. For these reasons, we believe that ISS should completely drop the "rigor of performance goals" qualitative factor. If ISS chooses to adopt this qualitative factor, then we recommend ISS provide expansive and detailed guidance as to how it will determine whether a performance goal is "rigorous."

- **The company's peer group benchmarking practices**. As with the other qualitative factors, we believe that ISS should provide additional guidance regarding the manner in which it will assess the adequacy of a company's "peer group benchmarking practices." For example, will the focus be on stated compensation objectives (e.g., 60^{th} percentile), the relative revenue or asset sizes of peer group companies, the range of revenues for peer group companies, the median revenues of the peer group, the industries represented in the peer group component companies, or other relevant factors. In addition, we highly encourage ISS to consider whether a company uses regression analysis to mitigate size differences among peers. Many companies do not have a robust group of peer companies within commonly acceptable size parameters. The use of regression allows them to make use of available peers while taking into account those size differences. This approach is common and should be acknowledged as acceptable.

- **Actual results of financial/operational metrics, such as growth in revenue, profit, cash flow, etc., both absolute and relative to peers**. The qualitative factor "actual results of financial and operational metrics" is also questionable. Such comparisons to peers are problematic, depending on whether the peer group consists of peers that the company directly competes with for business or talent. Moreover, ISS will have peer financials that were not available to compensation committees when they set CEO pay levels at the beginning of the year, and even when they pay bonuses at the end of the year.

In addition to the foregoing items, if ISS maintains the proposed approach to evaluating CEO pay for performance, additional guidance is necessary in the following areas:

- If a company has a new CEO that has served for less than two years, will ISS' pay-for-performance policy not apply? Similarly, if there is a change in CEOs during the three- and five-year measurement periods, how will pay for performance be assessed?

- Given that the proposed Policy Updates put more emphasis on long-term alignment, as well as overall alignment of CEO pay and TSR performance trends over five years, how will ISS treat public companies that do not have a five-year history of CEO pay and TSR performance?

- Will ISS continue to allow for a company to commit to "cure" a pay-for-performance disconnect, given that total shareholder return benchmarks that apply to each compensation year are not disclosed until after the close of the year, after a company may have made grants/awards that ultimately trigger ISS' policy?

Overall, we believe that this proposed Policy Update takes many steps in the right direction by providing less reliance on single hindsight factors. However, we believe the policy can be further enhanced with clarification in certain areas that would allow companies to anticipate and respond to new ISS' standards. Providing clear guidance to companies with suggestions on how to measure CEO pay with performance alignment should ultimately benefit issuers as well as shareholders.

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