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Members of the ISS Policy Committee
Via email

November 9, 2012

Subject: **Mercer Commentary on ISS's Proposed 2013 Policy Updates**

Mercer has reviewed the proposed ISS policy changes for 2013 related to executive remuneration. Specifically, we reviewed the proposed changes related to:

- Pay-for-Performance Evaluation – Peer Group Selection
- Pay-for-Performance Evaluation – Use of Realizable Pay within the Qualitative Analysis
- Pay-for-Performance Evaluation – Addition of Pledging of Shares as Problematic Practice
- Say on Golden Parachute Proposals
- Pay–for-Performance Policy Proposal for Canada

Our commentary and response to ISS questions are set forth below.

ISS Commentary Request: Pay for Performance Evaluation – Peer Group Selection

Mercer agrees that company peer organizations should be included in the ISS peer group assessment and should comprise a significant portion of the ISS comparator group. Most organizations compete for talent beyond their GICS code classification – especially for key executive talent. And for many organizations, it is challenging to identify a sufficiently large set of comparator organizations within the four-, six-, or eight-digit GICS groupings to make meaningful comparisons. We encourage ISS to incorporate at least 50 percent of the company's self-selected peer organizations in the ISS comparator group.

1. **Are there additional or alternative ways that ISS should use the company's self-selected peer group to inform its peer group construction?**

   ISS should also consider providing separate results (from its quantitative screening tests) within the ISS research report using only the company's self-selected peer group. We believe a review of the application of the company's assessment of its pay and performance alignment versus that of its peers' would provide a better indication of the compensation committee's decisions. Additionally, for many larger organizations where it remains challenging to find the requisite 14 companies within the GICS groupings to meet the ISS requirements, a greater proportion of the comparator organizations may need to come from the company's self-selected peer group.

2. **Since the company size is highly correlated with levels of executive pay, what is a reasonable size range (revenue/assets/market cap) for peer group construction?**

   We believe an appropriate size range to be 0.5X to 2X revenue/assets/market cap for comparator organizations within the peer group; however, it may be more important for the overall median size of the peer group to be within 0.5X to 2X the size of the company revenues or market cap. This may be especially true for companies where it is challenging to find a comparable peer group of 14 companies.

3. **Are there additional factors that investors should consider in peer group construction for pay-for-performance evaluation?**

   When selecting peer organizations, it is important to understand the impact of unique compensation arrangements on the pay-for-performance assessment. For example, companies with a founding CEO or those developing a succession or transition plan from a long-tenured CEO may have unique arrangements. Newly-elected CEOs and/or CEO departures often skew the peer group data, especially if the company has had multiple CEOs over the past five years or has a separate Chairman and CEO. CEO tenure and recent peer group company mergers may also play a factor in skewing peer company data. As part of the pay-for-performance analysis, ISS should consider providing information on the CEO positions within the peer group – including tenure of peer CEOs, how many also serve as Chairman, how many are newly appointed, how many did not receive incentives or equity, etc.

ISS Commentary Request: Pay for Performance Evaluation – Realizable Pay

Mercer is supportive of the use of realizable pay as a factor within the qualitative analysis as a way to measure a company's pay-for-performance alignment. It would provide a stronger correlation to total shareholder return (TSR) than grant-date (or accounting) value of compensation as it provides a better snapshot of the impact of company stock price performance on compensation value. We note that ISS commented that realizable pay would only be used for "large cap" companies. We recommend defining "large cap" companies for purposes of this assessment.

Additionally, while ISS intends to develop a policy that defines realizable pay, we also recommend ISS review any materials and analysis provided in the company's CD&A and proxy materials on realizable pay and company performance when conducting a pay-for-performance review. Often, there are compensation or performance issues unique to an organization that cannot be accommodated by one standard methodology, especially related to performance-based incentive compensation. For example, disclosure rules and accounting issues often create challenges to understanding the link between the performance period and corresponding compensation. Therefore, each company's unique issues should be considered.

1. **How would you define realizable pay?**

   Realizable pay would include the sum of the following: (a) base salary earned over the period; (b) short-term incentive compensation earned over the period; (c) the intrinsic value of restricted stock units/grants granted during the period; (d) the intrinsic value of stock option awards granted during the period, plus (e) the value of the performance award earned closest to the end of the period.

   We believe that looking at an annualized realizable pay figure will better allow for comparisons across companies that might have different incentive granting periods or executives who may not have been in their roles over the full period.

2. **Should stock options be considered based on intrinsic value or Black-Scholes value, and what is the rationale for your choice?**

   We would propose intrinsic value as that provides the actual value delivered for the stock price appreciation achieved. The individual is not guaranteed any future value unless the price appreciates in the future. Additionally, since restricted shares/awards are not revalued (for future stock price appreciation or dividend payments) but stock option would be under the Black-Scholes approach, company providing option grants may be penalized in a comparator peer study against those providing only full value grants.

3. **What should be an appropriate measurement period for realizable pay? One year, or three years, or five year or others?**

   We suggest using no less than three years as the measurement period for realizable pay. Using a five-year realizable approach may be challenging for peer organizations, especially where there are significant changes in the CEO positions and unique compensation arrangements. We have seen this in a number of cases with the five-year ISS review of CEO pay vs. actual TSR with prior CEOs.

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ISS Commentary Request: Pay for Performance Evaluation – Pledging of Company Stock

Upon review of the proposed policy, our primary concern is that ISS properly define the "pledging of company stock." The term pledging is often used as a term within the "internal" administration of a company's stock plan – for example, to pledge shares to pay future tax arrangements, to pledge shares to meet ownership requirements. Therefore, it is important for ISS to clarify the practice with which it is concerned. Many companies have adopted "anti-hedging" policies as a compensation risk mitigation tool to address potential governance concerns.

1. **What would you consider a "significant" level of pledging of company stock that causes concern for investors?**

   Mercer believes that ISS should support companies that adopt anti-hedging policies and disclose them in their proxy statements as required under the Dodd-Frank Act. We do not believe ISS should automatically recommend shareholders vote against say on pay proposals or members of the board of directors or committee members in 2013. Instead, we recommend ISS fully convey to companies (and ensure it fully understands from companies) the true meaning of pledged shares. We believe acceptable levels of pledging will vary by company depending on ownership structure, levels of stock ownership, and the executives and/or directors involved. Setting bright-line tests for acceptable levels may not be appropriate to address all situations.

2. **If pledging raises concerns significant enough to warrant significant enough to warrant voting action, should this action be directed at the (i) management say-on-pay proposal (if available), (ii) the board, or (iii) members of one of the board committees (e.g., audit, governance, compensation - please specify)?**

   Pledging of stock by executives should be one component of the say-on-pay review but should not alone be sufficient to trigger an automatic no vote recommendation. We believe that ISS should raise concerns in its say-on-pay analyses for 2013 about pledging to put companies on notice of its concerns. In future years, we believe the management say-on-pay proposal is the most appropriate vehicle to express dissatisfaction with a company's pledging policy. However, ISS should clarify in its report that the company's pledging policy or excessive pledging by executives was a significant factor in ISS's vote recommendation decision so companies understand the origin of the negative recommendation.

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3. **Would you consider a company's remedial actions on pledging such as a commitment not to pledge in the future, commitment to unwind their positions within a reasonable period) be sufficient to address concerns?**

We believe a future commitment not to pledge should be sufficient. There may be legal issues that prevent or delay a company from eliminating or “unwinding” current pledging arrangements. Pledging of shares has only recently been in the spotlight and some companies have not had the opportunity to adopt policies or review their practices and policies in light of recent shareholder concerns.

4. Are there additional factors that investors should consider for the case-by-case analysis?

We note that the level of disclosure regarding pledging of company stock by executives is inconsistent among organizations. The proposed ISS policy may intend to discourage companies from allowing executives to pledge shares but may instead penalize companies for providing clear and transparent disclosure. Again – we would encourage ISS to review the disclosure requirements and the definition of pledging vs. hedging and be consistent with the Dodd-Frank requirements.

As noted by other sources, we are in agreement that not all pledging of company shares by executives should be considered a problematic pay practice that carries weight sufficient to result in an adverse ISS recommendation. In certain circumstances, pledging may be appropriate. For example, not all pledging has the same negative consequences as hedging. Pledging on a limited basis by company founders who have a significant amount of their personal wealth in company stock may be appropriate. If founders are not allowed to diversify their investment in company stock they may become overly risk averse and make overly conservative decisions on behalf of the company. Executives who engage in limited pledging, for example using shares as collateral for a loan, retain title to the shares and their interests remain aligned with those of shareholders. We believe ISS should consider any limits placed on pledging activities and the actual amount of shares pledged in their case-by-case analysis of pledging.

ISS Commentary Request: Say on Golden Parachute Payments

Our primary concern with the proposed ISS policy on say on golden parachute payments is the problems that could arise if a contractual obligation that was in place well before a proposed transaction is voted down by shareholders. The proposed ISS policy could result in members of management negotiating their compensation arrangements during a pending transaction – an action that may not be in the best interest of shareholders. Additionally, golden parachute payments are often contractual rights the acquiring company must accept as part of the transaction.

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1. **In your organization's view, when evaluating payments arising from problematic pay practices in the context of a say on golden parachute proposal, would you differentiate between new and existing arrangements when determining whether to support the proposal? If yes, please specify.**

   Yes. Mercer would differentiate between new and longer-term arrangements for the reasons stated above.

2. **Would the number of problematic features be a consideration when evaluating a say on golden parachute proposal? If yes, please specify.**

   Yes. But say on golden parachute proposals should be reviewed on a case-by-case basis.

3. **Are there any other factors that should be considered in evaluating say on golden parachute proposals? If yes, please specify.**

   Yes. We believe ISS should review the structure, context, and size of the severance package provided to the individuals. Each situation should be reviewed on a case-by-case basis, depending on the terms of the transaction, structure of the combined organization and individuals' tenure, responsibilities and service with the combined firm. Additionally, the company's general compensation practices and policies should also be considered in the golden parachute assessment.

ISS Commentary Request – Pay for Performance (Canada)

1. ***Are there alternate or additional criteria that should be used in Canadian peer group construction other than size as determined by revenue/assets; industry group; and market capitalization? If yes, please specify.***

   A critical aspect of any pay-for-performance review is to ensure pay comparisons are made to an appropriate group of competitor organizations. Peer group development requires more analysis than simply comparing revenue size, market capitalization and GICS codes. ISS's proposed methodology for selecting peer companies – which largely replicates its 2012 methodology for US companies – may not accurately reflect a company's actual competitors for talent, performance, and investor dollars.

   In response to concerns raised by US companies regarding the 2012 peer selection process, ISS has proposed changing its US policies to consider a company's self-selected peer group and the GICS industry groups represented by the company's self-selected peers. The process is designed to select peers that are closest to the company in terms of revenue or assets and industry and market cap, prioritizing those that keep the company near the median of the peer group, are in the company's own selected peer group and have chosen the company as a peer. We believe this change should also be incorporated into the proposed Canadian policy as it will result in a more appropriate peer group and provide investors with a better understanding of how the company's compensation committee evaluated relative pay-for-performance when determining the CEO's pay package. Also, using the proposed methodology may produce fewer than the desired 11-24 companies. For example, Mercer recently tried to replicate a peer group for a Canadian client applying the proposed ISS model – only eight companies resulted from the simulation, two of which were not in the company's line of business.

We also recommend ISS consider including US companies when selecting peers for certain Canadian companies (currently only Canadian companies are used). Many Canadian companies have significant operations in the US and compete with US companies for talent. And similar to the issue raised above, using only Canadian companies for the peer assessment for these companies would exclude their true competitors and may produce fewer than the desired 11-24 companies. For example, Mercer has several clients with a significant presence in the US and few similar companies of like-size in Canada.

Finally, we recommend ISS clarify how market capitalization will be considered in selecting peer group companies, including disclosing the size range for the four market cap "buckets" (micro, small, mid and large). This will help companies anticipate which companies are likely to be included in their ISS peer group.

2. ***Is the 40/60 weighting on the one- and three-year, respectively, for TSR rank, and CEO pay rank (which gives more weight to the longer term three-year component) appropriate in your organization's view? If no, please specify.***

We support greater weight being given to long-term performance. However, given that a portion of the three-year component is one-year pay and performance, there may still be an overemphasis on one-year pay and performance. In this volatile market, sharp swings in company performance are likely to continue in 2013 and just one year of weak performance could quickly move a company from a top performer to the bottom without adequate time for adjustments to be reflected in CEO pay. We recommend ISS consider such anomalies in its qualitative assessment.

3. ***Does your organization consider any additional significant factors, other than those listed in ISS' qualitative evaluation component of the proposed methodology? If yes, please specify.***

We consider the following additional factors when analyzing pay-for-performance at client companies and recommend ISS consider them in its pay-for-performance analysis:

- We suggest ISS consider "realizable pay" in its qualitative analysis under the Canadian policies as it has proposed in the US policy updates. Using the total compensation figure included in the summary compensation table, which values equity awards at their grant date fair value, fails to take into account that those amounts may never actually be received or realized by the executives. For example, if stock price declines, options may become underwater and equity compensation may lose a portion of its value – which demonstrates pay-for-performance alignment.

- Not exempting new CEOs from the quantitative screen could result in inappropriate pay and performance comparisons since incumbent and newly hired or promoted CEOs may have different pay programs and levels. In addition, companies that replace an ineffective CEO may be penalized, with the new CEO held accountable for the prior CEO's poor performance. While extraordinary situations due to a new CEO is a factor included in the qualitative analysis, based on feedback from our US clients with new CEOs last year, we are concerned that ISS did not sufficiently consider compensation associated with CEO attraction and retention in its qualitative analysis.

Other comments

We assume the final policies will include greater detail than the proposed updates. For example, the US policies, White Paper and FAQs addressed several items not currently covered, including:

- Detailed information on the selection of peer groups and the mechanics of the quantitative analysis
- Clarification that peer groups are constructed twice a year (December 1 and June 1) using the following quarterly data provided by Research Insight: (i) revenue – sum of most recent trailing four quarters' revenues, (ii) total assets – most recent quarter's total assets, (iii) market value – 200-day average stock price times shares outstanding
- Explanation of the results of the quantitative analysis, including high, medium and low levels of concern
- Quantitative test result levels that may trigger high concern in conjunction with other measures and level of concern that triggers high concern by itself
- Impact of quantitative test results that trigger high concern and lead to a qualitative assessment
- Effects of failing both the quantitative and qualitative tests, for example, whether ISS is likely to recommend a vote against the company's say-on-pay proposal and could possibly recommend an "against" or "withhold" vote on compensation committee members
- What happens when a company has more than one CEO during a year

MERCER

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Thank you for giving Mercer an opportunity to respond to your proposed proxy voting guidelines. Mercer is a leading global provider of consulting, outsourcing and investment services, with more than 25,000 clients worldwide and approximately 10,000 in the United States and 3,400 in Canada. Mercer consultants help clients maximize the effectiveness of their compensation and benefit programs and optimize workforce performance by providing human resources and related financial advice, products, and services, including executive and director compensation consulting services to corporations, boards of directors and board compensation committees.

Should you have questions regarding our submission, please contact Kelly Crean, Leader of Mercer's Governance, Shareowner and Equity (GSE) Team, at 404 442 3504.

Respectfully,

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