October 31, 2012

ISS Global Policy Board
Institutional Shareholder Services Inc.

Dear Policy Review Board:

Pay Governance LLC is pleased to share with you our comments on ISS' 2013 Draft Policies. Given the nature of our role as remuneration advisors to issuers, we focus our comments on those matters relating to your Compensation policies.

Management Say-On-Pay Proposals (U.S.)

We are generally encouraged by the nature of ISS' proposed policy changes for 2013. We believe consideration of issuers' selected peers and the use of realizable pay as a factor in gauging pay-for-performance alignment represent improvements in ISS' evaluation protocol. Further, we acknowledge the potential for pledging of shares to affect the economic exposure of company executives, but believe ISS should ensure that any policy appropriately balance investors' concerns about excessive pledging with providing executives a reasonable degree of flexibility to manage their personal portfolios.

Construction and Use of Peer Groups

While we support ISS' effort to consider issuer-selected peer companies, we are concerned that the proposed approach will fail to satisfy either issuers or investors. Rather, we believe all parties would be best served by presenting pay-for-performance evaluation results based on ***both*** (i) an ISS-selected set of peers identified under ISS' current approach (i.e., 2012 policy) and (ii) the set of issuer-selected peers. This approach would seem satisfactory to investors, 67% of which supported ISS' development of its own peer group (according to the recent 2012-2013 Policy Survey) and most of which rated the identification of peers within the same GICS code as either very or somewhat relevant. In recognition of the significant amount of time and resources expended by issuers to identify peers representative of their market for talent, incorporating issuer-selected peers as part of ISS' pay-for-performance evaluations would provide investors the ability to directly evaluate and consider the appropriateness and influence (if any) of the issuer-selected peers.

In addition, we believe ISS should consider identifying its own set of peers at the beginning of the issuer's fiscal year rather than at the end of the fiscal year. We believe doing so would: (i) be more consistent with the process reasonably used by issuers to identify companies against whom they

Bentham W. Stradley, Managing Partner
5601 Granite Parkway, Suite 270 | Plano, TX 75024 | 972 379 7468 | bentham.stradley@paygovernance.com

might reasonably evaluate performance during the course of the fiscal year, (ii) provide sufficient time for ISS to identify and communicate to issuers the constituents of the ISS-selected peers and (iii) limit the potential survivorship or other biases that might arise from selecting peers at the end of the fiscal period. To the extent an issuer undergoes a material change in its business during the course of the fiscal year (e.g., merger, spin-off, etc.), we believe it would not be unreasonable for ISS to reevaluate the composition of its peer group at that time.

Measuring Pay-for-Performance Alignment

We strongly support ISS' consideration of alternatives to the Summary Compensation Table-disclosed pay opportunity figures. Realized pay (i.e., actual salary, bonus and value received from vesting of stock awards and exercise of stock options) is one viable alternative that measures the value received by executives. However, over shorter time frames, this measure could fluctuate significantly from period-to-period due to executive decisions regarding the timing of equity vesting and stock option exercise decisions. Measures of realizable pay (i.e., actual salary, bonus and in-the-money value of completed and in-cycle long-term incentives) moderate this concern, but present an element of uncertainty as equity values remain contingent on future performance and stock price movements.

While valid and substantive arguments can be made in support of both measures, we support ISS' consideration of realizable pay in its evaluation of pay-for-performance alignment and suggest ISS make realizable pay its primary gauge of the effectiveness of the pay program in making its determinations.

Both investors and issuers responding to ISS' 2012-2013 Policy Survey indicated strong support for the use of realizable pay, with more than 60% indicating support for its role in a quantitative evaluation of pay-for-performance. We believe realizable pay – measuring pay delivered in light of company performance – is an appropriate indicator of the extent to which pay responds to actual company performance. Our own research in the area has indicated that realizable pay may be a better indicator of pay-for-performance alignment than the current approach based on pay opportunities (refer to our recently published book, *Executive Pay at a Turning Point* for additional information). Further, our research confirms that above-market pay opportunities may contribute to a breakdown in pay-for-performance alignment, but the actual delivery of pay remains dependent on the relative difficulty of performance and other criteria.

To the extent ISS pursues the use of realizable pay in its pay-for-performance evaluation, we believe it should be measured as the sum of: (i) base salary, (ii) actual short-term incentive awards and bonuses earned, (iii) the end-of-period *intrinsic* value of stock options and restricted stock / unit awards granted during the measurement period (iv) the value of performance awards earned during the measurement period, and (v) the end-of-period intrinsic value of in-cycle performance awards (based on the payout disclosed in issuers' Outstanding Equity Awards at Fiscal Year-End table, or if unavailable, assuming target performance). For our own purposes, we typically evaluate realizable pay on both absolute and relative bases over historical periods of 3 years, although we would not consider a longer period of 5 years to be unreasonable.

While realizable pay may be defined several different ways, we believe our approach provides a reasonable estimate of the compensatory value of compensation awarded during the measurement period – which directly corresponds to company performance over the same period. We are concerned that other approaches (e.g., measuring the Black-Scholes value of stock options) result in the measurement including value that may, for example, be associated with stock options that are underwater and, therefore, do not have any compensatory value to the optionee. Further, alternative measures of the value of a stock option (such as Black-Scholes) will result in inconsistencies in the measurement of value realizable by the optionee. For example, a $1 increase in the intrinsic value of an option would translate into an increased expected (e.g., Black-Scholes) value of less than $1; similarly, for an underwater option, an increase in stock price may not translate into any incremental value to the optionee, despite an apparent increase in the Black-Scholes value of the option.

We encourage ISS to consider revisiting its pay-for-performance evaluation methodology to make realizable pay its principal quantitative test for gauging alignment relative to peers and relative to historical company performance. We believe this perspective would provide a better indication of the extent to which the issuer's compensation arrangements are functioning as intended than tests based on grant value. Acknowledging that the potential for misalignment begins with outsized pay opportunities, we would continue to support ISS' use of grant value as the basis of measurement in its Multiple of Median (MOM) quantitative test.

Finally, adoption of the proposed 2013 Draft Policies would result in three consecutive years of significant changes to ISS' pay-for-performance evaluation methodology. While we recognize the continuous change in governance and pay practices – as well as the importance of continuous improvement in ISS' methodologies – we are concerned that the pace and magnitude of these changes are highly disruptive and distracting to all parties, making it difficult (if not impossible) to monitor progress and/or year-over-year improvements in the governance of executive pay programs. Therefore, we suggest that to the extent ISS adopts further changes to its pay-for-performance evaluation methodologies, it performs all issuer evaluations under both former and new evaluation protocols to ensure that vote recommendations reflect fundamental pay-for-performance breakdowns that arise due to issuer administration of their programs, rather than solely due to a change in ISS' evaluation protocols.

Pledging of Company Stock

As noted above, we recognize the potential for pledging of shares to affect the economic exposure of company executives but caution ISS to ensure that any policy appropriately balance investors' concerns about excessive pledging while providing executives a reasonable degree of flexibility to manage their personal portfolios.

Although we do not endorse executive pledging of company stock, we do not believe ISS should adopt a bright line test in gauging the potential of pledging to be considered “problematic.” Instead, we suggest ISS evaluate each situation on a case-by-case basis, considering:

- The dollar value of pledged shares (in both absolute terms and as a % of market capitalization);
- The dollar value of pledged shares as a proportion of total executive stock holdings; and
- The extent to which pledged shares encroach on stock held by the executive that is subject to stock ownership and/or stock retention requirements.

Collectively, we believe these criteria would provide investors with sufficient information to make informed judgments as to the potential consequences of events that might trigger unexpected or unplanned stock sales by the executive.

In the spirit of providing investors with sufficient information to make informed judgments, we do not believe ISS should directly consider these factors in its Management Say On Pay vote recommendations. Rather, we believe pledging (and similar indicators ISS deems “problematic”) should only be identified by ISS in its reports, allowing individual investors to consider the degree of overall balance in the issuers’ compensation arrangements.

Say on Golden Parachute Proposals (U.S.)

In recent years, U.S. companies have been addressing many severance features deemed “problematic” by ISS and other institutional investor advisors. As such, we believe the current emphasis on such “problematic” provisions in recent agreements continues to be an effective mechanism for investors to express their concerns.

Further, under the current disclosure regime, issuers are required to detail termination payments to executives as part of their annual proxy statement filings, providing details as to the benefits received by each executive. Therefore, we do not see the proposed change in policy resulting in any additional clarity about the amount or form of termination payments being made available to investors as a result of this policy change. As a result, we see no need for ISS to revisit its current policies on this topic at this time.

Pay for Performance (Canada)

Based on our understanding of the proposed policy changes, it appears that ISS is proposing to adopt pay-for-performance evaluation criteria for Canada which are similar to those currently applied to U.S. issuers. Given both the geographic proximity and similarities among the U.S. and Canadian markets, we support the use of a consistent evaluation framework across the broader North American continent.

However, based on our experience in the U.S., we have some concerns with ISS' ability to identify industry-specific peers limited solely to the Canadian marketplace. To address this, we understand ISS may consider relaxing its minimum requirement of 11 peer companies in certain situations. We are concerned that doing so would reduce the significance of CEO pay and total shareholder return statistics underlying the Relative Degree of Alignment (RDA) test ISS intends to apply beginning in 2013. This could result in several companies "failing" ISS' RDA test, when it would otherwise be inappropriate to do so.

In light of this – and given the degree of cross-border competition among U.S. and Canadian companies (and proximity of several major business centers) – we believe in certain circumstances it may be appropriate for ISS to consider potential peer companies from among the larger universe of U.S. and Canadian public companies. We believe this would only be appropriate in limited circumstances and only in those situations involving the largest public Canadian companies. Given the comparatively-larger set of U.S. companies, we do not believe it would be necessary for ISS to pursue a similar policy for U.S. issuers.

Finally, consistent with our comments above indicating our preference to gauge alignment based on realizable (or realized) pay statistics, we believe ISS should consider adopting a consistent methodology for all pay-for-performance evaluations – including those for Canadian companies. We recognize that this represents a step beyond ISS' current proposed 2013 Draft Policies and, therefore, suggest <u>*at a minimum*</u> that ISS consider realizable pay as an aspect of its qualitative evaluation for 2013, with the intent of more fully-incorporating this perspective into its 2014 policies.

*   *   *

If you have any questions, or would like to further discuss the substance of our comments, do not hesitate to contact me directly.

Regards,

BWStradley

Bentham W. Stradley
Managing Partner