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ISS Global Policy Board
Institutional Shareholder Services Inc.
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Subject: Comments on ISS' Draft 2019 Proxy Voting Policies (U.S.)

Compensation Advisory Partners LLC ("CAP") appreciates the opportunity to comment on the draft 2019 proxy voting policies related to compensation.

CAP is an independent consulting firm that helps clients make informed decisions about executive and non-employee director compensation and related corporate governance matters. We believe compensation should be used as a management tool to support business strategy. Our consultants serve as independent advisors to Boards and senior management at many leading companies and share ISS' interest in advancing sound corporate governance.

Our comments are detailed below.

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ISS Pay-for-Performance Model (U.S.)

ISS will recommend shareholders vote against Say on Pay resolutions if there is a perceived misalignment between CEO pay and company performance, based on ISS quantitative tests and ISS' qualitative review of the executive pay program and related Compensation Committee decisions. If the quantitative tests yield a favorable result (i.e., "Low" or "Cautionary Low" concern), a favorable Say on Pay vote recommendation from ISS is very likely.

Prior to 2018, ISS' quantitative screening methodology only measured company performance using total shareholder return ("TSR"). Beginning in 2018, ISS introduced the "Financial Performance Assessment" or FPA, as a modifier to the primary pay-for-performance screen. The FPA is used only to potentially adjust upwards the concern level of companies that receive "Cautionary Low" concern on the primary screen, but demonstrate "poor" economic performance, and to adjust downwards the concern level of companies that receive a "Medium" concern on the primary screen, but have shown "strong" economic performance.

ISS is considering certain compensation-related (U.S.) policy changes for 2019:

- "ISS proposes to update ISS' secondary FPA screen… by replacing existing unadjusted GAAP accounting measures with improved EVA-based measures… Specifically, the FPA would shift its capital productivity and profitability measures from GAAP-based measures of ROA, ROE, and ROIC to EVA concepts of EVA Spread and EVA Margin, measured over a three-year period. In addition, measures of company progress no longer would be based on EBITDA growth and cash flow growth; rather, EVA concepts of EVA

Momentum, denominated by capital and sales, would be used to measure a company's economic growth trajectory."

- "…. The proposal would simplify the FPA methodology: each EVA metric will be weighted equally, and the weightings will be the same for all companies in all industries."

ISS' proposed update centers on the measures in the secondary FPA screen. The framework of the FPA screen (i.e., its use as a secondary screen following the primary screens which will still rely on TSR) will be maintained.

ISS Request for Comment – #1
"Under this proposed update, the framework of the primary ISS pay-for-performance model methodology is unchanged and will continue to use TSR as its main performance metric. Does your organization agree with that approach? If not, please explain."

CAP PERSPECTIVE:

Yes, for a test that is applied across industries, we believe TSR is the most appropriate performance metric. However, we ask ISS to provide its reasoning as to why it is appropriate to weigh recent pay and performance more in the PTA test, but not in the RDA test. We believe that recent Committee decisions best relate to company performance over time.

ISS Request for Comment – #2
"If the existing FPA screen performance measures are replaced with EVA-based measures, would you prefer that ISS continue to display GAAP performance data for informational purposes?"

CAP PERSPECTIVE:

We support including data in the ISS proxy report (compensation section) that contributes to the Say on Pay vote recommendation. Showing data not being used can lead to mixed messaging.

ISS Request for Comment – Other
"We will appreciate any comments on this topic…"
Below we provide additional comments and changes that we urge ISS to consider related to the ISS Pay-for-Performance Model (U.S.).

CAP PERSPECTIVE: FPA Assessment Methodology (secondary screen)

<u>While we support simplification of the FPA screen, we do not support replacing existing measures with EVA-based measures. While EVA may be favored for its measure of value creation, we believe it is flawed for various reasons. Specifically:</u>

- While EVA data will be provided to covered issuers to help understand the information, EVA can be a challenging concept and one that is not well or widely understood. It is based on many unique assumptions and potential adjustments for each company and can be hard for issuers or investors to replicate or project in advance
- It is difficult to compare results across companies based on EVA measurements. It is also difficult to reconcile findings from an EVA measurement to findings based on GAAP financial results, which is what most companies and investors use
- Use of EVA is not on an upward trend, and we have not heard institutional investors encouraging a change to EVA- based metrics
- It is not clear that EVA is a superior metric providing better insights into a company's performance than the current metrics used, which already emphasize returns/capital productivity and are balanced with profitability measures
- In our experience, line-of-sight and clarity are valued by investors and participants in incentive plans. We believe changing the FPA metrics, as proposed, would distance this evaluation from key performance metrics often cited by institutional investors and included in company business plans and incentive plans
- ISS only recently (i.e., beginning in 2018) adopted the current approach to the FPA screen. Frequently changing methodology, in our experience, makes an evaluation less credible

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ADDITIONAL CAP PERSPECTIVE:

RDA and MOM Tests – Peer Group

From what we have observed, it is typical for the composition of our clients' ISS-defined peer groups to change, to some degree, each year, oftentimes without compelling reason(s) for change. The result of peer turnover is a moving target and creates uncertainty each year around getting a favorable result on ISS' quantitative CEO pay versus performance tests. This is not a good thing.

<u>We strongly encourage ISS to consider modifying its approach to annual changes to ISS-defined peer groups. Greater year-over-year consistency would be a significant improvement</u>.

- Absent compelling reason(s) for change, there should be no changes to an ISS-defined peer group from one year to the next
- When changes are made to an ISS-defined peer group, the rationale for such change(s) should be included in the relevant annual ISS proxy report

Our two suggested changes (above) would better align ISS' approach with typical market and certain best practices.

- Absent compelling reason(s) for change, corporate issuers generally seek to avoid making changes to their peer group each year. It is typical to validate peer groups on an annual basis (e.g., were any companies acquired?) and do a more comprehensive review every two to three years. Our understanding, from both an institutional investor and corporate issuer perspective, is that line-of-sight in executive compensation programs, for decision-makers and participants, is valued and encouraged. Year-over-year consistency in the peer group composition would provide more meaningful and actionable data and comparisons to issuers.

- When (benchmarking) peer group changes are made, corporate issuers include the rationale for such change(s) in their CD&A. Our understanding is that ISS encourages such transparency. ISS should hold itself to a similar standard. If ISS were to limit peer group changes to instances with compelling rationale, such disclosure should not be difficult or time consuming to complete.

The increased year-over-year consistency in ISS peer groups, as suggested, would reduce unexpected outcomes from ISS' quantitative, relative CEO pay versus performance tests. Such outcomes should not come as a surprise resulting from peer group changes.

- ISS-defined peer groups generally contain 12-24 companies[1]. Changing only a few peer companies from one year to the next, given the size of this data set, can have a significant impact on (i.e., can materially change) the result of the relative quantitative tests

Finally, the ISS document "U.S. Peer Group Selection Methodology and Issuer Submission Process – Frequently Asked Questions" includes certain factors ISS places "priority" on in its annual peer group assessment methodology. We suggest that "consistency" – where a compelling rationale for change does not exist – be added to the list of priorities.

RDA Test – Compensation

We continue to recommend and support that ISS use realizable pay in the RDA test (with ISS' current definition and assumptions), instead of grant date pay. Realizable pay would better show if pay was aligned with performance over time.

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CAP is submitting commentary on its own behalf and not on behalf of any specific client(s). Please contact the authors, listed below, if you would like to discuss our comments.

[1] Aligns with typical market practice. See Equilar Peer Group Composition and Benchmarking Report (July 2017).

Best Regards,

COMPENSATION ADVISORY PARTNERS LLC

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