MEMORANDUM

FREDERIC W. COOK & CO., INC.
685 THIRD AVENUE, 28TH FLOOR NEW YORK, NY 10017
NEW YORK • CHICAGO • LOS ANGELES • SAN FRANCISCO • ATLANTA • HOUSTON • BOSTON

TO: Institutional Shareholder Services Research **DATE:** 11/9/15

FROM: Jarret Sues and Cimi Silverberg

SUBJECT: Compensation Disclosure at Externally-Managed Issuers

This memorandum presents observations and comments on Institutional Shareholder Services Research's ("ISS") draft policy change proposal related to compensation disclosure for externally-managed issuers ("EMI").

BACKGROUND

ISS has requested comment as it pertains to the following questions:

- Does your organization agree that an "Against" vote recommendation for an externally-managed company's say-on-pay proposal is appropriate when the company does not provide sufficient disclosure on executive's compensation arrangements with the external manager? ("Question 1")

- What factors should ISS consider in gauging potential conflicts of interest underpinning executives' compensation arrangements with the external manager? ("Question 2")

- Do you see any unintended consequences that may result from the proposed policy update? ("Question 3")

Question #1

We do not agree that an "Against" vote recommendation for an externally-managed company's say-on-pay proposal is appropriate when the company does not provide sufficient disclosure on executive's compensation arrangements with the external manager, for the following reasons:

- ISS' proposed policy would require disclosure of confidential information

    — The typical nature of the relationship between an external manager and an EMI is that management of the business is conducted by the external manager, typically a private entity, in exchange for management and other fees from the EMI. All such fees are outlined in a management agreement

    — The EMI typically has no employees; the executives of the EMI are employees of the external manager, not the EMI itself

  - -- EMIs, being publicly traded, are required by the SEC to disclose compensation information and decisions under the public EMI's purview, which includes the terms of the management agreement, the fees paid to the external manager, and compensation it directly provides to executives (if any)

  - -- The external manager, a private entity, is not required to disclose the compensation it provides to individual employees. Since the executives of the EMI are employees of the external manager, disclosure of compensation paid by the manager to individual executives is not required. ISS' proposed policy change threatens an "against" recommendation for say-on-pay unless the manager, a private entity, voluntarily discloses certain confidential compensation information

- Compensation/allocation decisions relating to external manager employees, including EMI executives, are not under the purview of the EMI's compensation committee. In most cases, the EMI's compensation committee has no knowledge of how its management fees are allocated to individual employees of the external manager. ISS' proposed policy change would hold the publicly traded EMI board accountable for decisions they are not making

- ISS writes, "Without sufficient disclosure regarding the structure of executive compensation arrangements and payments made to the executives, it is <u>impossible</u> for shareholders to assess pay programs and their linkage to company performance."

  - — We disagree with the suggestion that it is <u>impossible</u> to assess pay and performance. Detailed information regarding fees that the EMI is paying to the external manager is made public, including the nature and size of those fees, and the contractual agreement under which the external manager provides services in exchange for such fees. This information is sufficient for investors to gain insight on pay and performance

- We further disagree with ISS' statement, "…a management structure in which executives are compensated by the external manager rather than the issuer raises questions about the potential conflicts of interests underpinning such compensation arrangements. Without disclosure surrounding compensation arrangements, shareholders are unable to judge whether pay programs create incentives in the best interest of shareholders (as opposed to the external manager)."

  - — The EMI pays the external manager pursuant to a management agreement, which includes pre-established formulas for fees. These agreements negotiated at arms-length and filed with the SEC, and the amount of fees being paid by the EMI to the external manager pursuant to those agreements is publicly disclosed. The allocation of fees is not relevant to the determination of whether the management agreement creates the appropriate incentives. What is relevant is whether the terms of the management agreement (i.e., the fee formulas) are competitive with other similarly-situated companies, and the information for this determination is readily available to shareholders. An EMI paying fees higher than the "going rate," can terminate its management agreement and enter into an agreement with another manager with more competitive fees

Question #2

ISS should consider the following factors in gauging potential conflicts of interest underpinning executives' compensation arrangements with the external manager:

- The terms of the management agreement, including the fee structure (i.e., formula) compared to other similarly-situated EMIs

- The amount of fees paid to the external manager by and from the EMI

- Any additional compensation awarded by the EMI directly to executives

- Executives' interests in other public/private companies with "connections" to the external manager (i.e., related party transactions)

Question #3

The following unintended consequences may result if the proposed policy is implemented:

- External managers could be discouraged from providing services to publicly-traded EMIs amid pressure to disclose confidential information

- External managers and/or EMIs may petition the SEC to make them aware of what could be categorized as an "overreach" by ISS asking for information they are not legally bound to provide

- The additional disclosure subjects directors to additional legal liability as the directors of the public EMI are ultimately responsible for the materiality and accuracy of that disclosure

- The additional cost to the EMI associated with disclosure and calculation; including the potential cost of engaging professionals such as SEC attorneys, accountants and consultants (i.e., the compliance cost overlay)

- Under the current external manager – EMI relationship there can be an expectation of executive privacy given the fact the SEC does not require individual pay disclosure of executives employed by the private entity. ISS' proposal would seek to infringe upon that privacy

- ISS' proposal would set the precedent of expectation of a private entity's disclosure of information in a public forum, which we contend is a bad precedent to set