Center On Executive Compensation

August 17, 2012

VIA EMAIL

Dr. Martha Carter
Chair
Global Policy Board
Institutional Shareholder Services, Inc.
2099 Gaither Road
Rockville, MD 20850-4045

RE: Center On Executive Compensation Response to 2013 ISS Policy Survey

Dear Dr. Carter:

The Center On Executive Compensation ("Center") is pleased to submit its responses to and qualitative comments on Institutional Shareholder Services, Inc.'s ("ISS") 2013 Policy Survey on behalf of its Subscribers. The Center was heartened to see that this year's Policy Survey included more substantive questions regarding executive compensation than in previous years, and continues to believe that direct engagement between ISS and issuers will enhance ISS's policy development and further the progress of all stakeholders in achieving clarity on executive compensation issues. We are hopeful that the views and experiences of companies will be given considerable weight as ISS considers the changes it will make to its policies going forward, especially in the areas of peer group selection and pay for performance analysis, about which both investors and companies raised concerns during the 2012 proxy season.

As you know, the Center is a research and advocacy organization that seeks to provide a principles-based approach to executive compensation policy from the perspective of the senior human resource officers of leading companies. The Center is a division of HR Policy Association, which represents the chief human resource officers of over 335 large companies, and the Center's 100 subscribing companies are HR Policy members who represent a broad-cross-section of industries. Because senior human resource officers play an important role in supporting the compensation committee, we believe that our Subscribers' views are particularly helpful in better understanding how executive compensation plans are developed and executed, especially in the era of say on pay. Consistent with the Center's mission, our comments and survey responses are focused on ISS's survey questions regarding executive compensation and related governance issues.

www.ExecComp.org
1100 Thirteenth Street, NW
Suite 850
Washington, DC 20005
info@ExecComp.org
202.408.8181
202.449.5648

Peer Groups (Questions 16 and 17)

A. Appropriate Peer Group for Pay for Performance Analysis

In this era of mandated say on pay, proper peer group selection is more important than ever. Peer groups are foundational to the analysis of the alignment of pay and performance; an improperly defined peer group can skew data and misrepresent the real connection of pay to performance for a company. ISS's pay for performance analysis, with its focus on relative short-term performance, relies heavily on peer groups, but uses a predominantly GICS-based methodology which seems to have increasingly yielded illogical groups of peer companies. Both data and anecdotal information seem to reinforce this concern.

- As of August 10, according to Semler-Brossy, 24 out of 40 S&P 500 companies who filed supplemental information with the SEC involved debates about peer group selection by proxy advisory firms or other analysts, most of which referenced ISS in response to their proxy filings.
- In addition to companies, analysts for some large institutional investors have started questioning the propriety of the ISS GICS-based methodology. In some cases, the investors have sought to develop their own peer groups as an alternative based in part on the competitors against which their investment analysts compare issuers.
- The concern over peers has also attracted the attention of the SEC. In a speech to the National Investor Relations Institute, Meredith Cross, the Director of the SEC's Division of Corporation Finance, indicated that her team would like to learn more about company concerns about peer group selection by proxy advisors, noting that the staff had heard many complaints about these issues this year.

The fact that a variety of different stakeholders are raising similar questions reinforces our view that the ISS methodology deserves comprehensive review and revision before the 2013 proxy season. Our results from the ISS policy survey also reinforce this.

- No Center Subscribers agreed with the continuation of ISS's current practice of creating its own peer group for each company without comparing it to the company's peer group.
- More than half (57%) of Subscribers believe that ISS should use the company's peer group in its pay for performance analysis, with or without the addition of ISS's standards for peer company size. Of those, just over half (52%) believe that ISS should use the company's peer group without exception, while just under half (48%) believe that ISS should use the company's peer group subject to ISS standards for peer company size. These results reflect companies' strong belief that the time, effort and reasoned thought that go into the board's selection of peer groups deserve deference when considering relative pay and performance. One Subscriber also commented that it is important to differentiate between the

committee's establishment of appropriate peer groups and the committee's compensation decisions based on those peer groups, and encouraged ISS to "separate its evaluation of whether it believes each issuer's peer group is appropriate from its analysis of how, given a certain peer group, an issuer sets compensation for its own officers."

- 20% of Subscribers selected "other" in response to this question; most of these anecdotally indicated that because companies take a carefully constructed approach to developing peer groups, ISS should undertake more qualitative analysis. One Subscriber noted that at a minimum, ISS should include the company's peer group as a comparison point in its own analysis and indicate whether its voting recommendation would have changed had it used the company's peer group in its review.

Companies recognize the necessity for ISS to conduct its own, independent evaluation of the peer groups selected and disclosed by companies; in fact, several Subscribers noted that they would expect ISS to use a "size lens" or note when the company peer group "includes a significant deviation from pre-defined peer group standards." However, the Center and its Subscribers continue to believe that the compensation committee is best positioned to assess which companies should be included in the company's comparator group, taking into account industry, size, scope of complexity and the market in which the company competes for talent. As one Subscriber noted, in some cases, especially those involving large companies, two peer groups are necessary in order to "accurately reflect both the market for talent and the market for goods and services in which the company competes." The Center additionally believes that companies need to disclose how peers were selected and in certain cases, provide sufficient information for investors and proxy advisors to understand why certain companies were included.

B. Relevant Factors for Constructing Peer Groups

Question 17 asked how relevant factors such as size, GICS code, and company peer selection should be to ISS's peer group methodology.

- While responses were varied, emphasizing the very contextual and company-specific nature of executive compensation and the importance of the reasoned judgment of the board, the factor most commonly indicated as "very relevant" was whether the ISS-selected peer was included in the target company's published peer group.

- Size was also considered by most Subscribers to be a relevant factor in peer group selection; the majority (82%) responded that the question of whether a peer company fell within a specified size range of the target company (*e.g.*, between 0.5 and 2 times the company's revenue) was relevant.

- The question of whether an ISS peer company falls in the same GICS group as the target company or its peers received the least relevant responses; 35% of Subscribers indicated that the ISS peer sharing a GICS group with the target company was less than relevant while 44% indicated it was either less than relevant or not relevant at all. More companies believed it was relevant that the ISS peer had chosen the company as a peer (53%) than that the ISS peer shared a GICS group as one or more of the company's peers (42%).

These results reflect the fact that the often random groups of companies generated by solely comparing GICS codes do not take into account differing business models, complexity of operations, global footprint (as one Subscriber noted, "comparing companies that are predominantly North American to a global company is a bad comparison") or business cyclicality, all of which the compensation committee considers when determining an appropriate peer group.

Pay for Performance (Questions 18-20)

A. Performance Metrics and TSR

We asked our Subscribers for their feedback about how companies are engaging with investors regarding measures of performance other than Total Shareholder Return ("TSR"). The majority of Subscribers (76%) responded that they believed their investors were somewhat or very likely to consider performance metrics other than TSR, most commonly measures related to revenue, earnings, cash flow, and return on capital. This feedback illustrates the way that institutional investors are increasingly saying they look at pay – not through a single lens of stock price fluctuations, but through a more nuanced analysis of how pay is generated by both financial and non-financial metrics and how this translates into investor returns over time.

The variety of metrics named in responses demonstrates the highly company-specific nature of judging performance and the importance of a pay for performance analytical methodology which takes into account the needs of companies to use the performance metrics which most effectively drive results for them.

B. Appropriate Measures of Pay

The majority of Center Subscribers (84%) believe that alternate measures of pay to the grant-based pay disclosed in the Summary Compensation Table, such as "realized" or "realizable" pay, should be considered when measuring and analyzing pay. As one Subscriber put it, "Although it is complex, only in considering both granted and realized pay will the investor understand both the decisions made by the Compensation Committee and the tie to actual pay for performance" at the end of the performance period. The Center continues to believe that a realized pay approach, which assesses whether pay actually realized was aligned with the performance which drove it, gives the clearest explanation of the link between pay and performance. This avoids the "apples-to-oranges" analysis of combining actual and future potential pay and leads to a more consistent pay for performance assessment. In disclosing realized pay, the Center also continues to believe that it is important to link the pay that results from long-term incentives with the time period over which it was earned enabling shareholders to determine pay and performance alignment over consistent time periods.

The majority (79.5%) of Subscribers consider a standardized calculation of realized or realizable pay appropriate for the evaluation of pay and performance. This reinforces what we have heard anecdotally from several large institutional investors, namely that a standardized disclosure facilitates a clearer understanding of how pay plans operate in relation to performance. The use of realized pay disclosures has increased considerably over the past few years, in part due to mandatory say on pay votes. Based on our discussions with companies, realized pay is valued because it helps tell a company's story about how actual pay is linked to performance. In addition, several investors have indicated that realized pay disclosures provide a complete picture of whether the board's intention in granting pay was realized or whether pay and performance were misaligned over a particular period of time.

Outreach and Engagement (questions 6, 8 and 10)

The 2013 survey included several questions relevant to issuers on ISS's outreach activities and engagement process. The Center continues to believe that engagement between issuers and ISS is the best way to avoid unintended consequences, including potential material inaccuracies and to facilitate a clearer understanding of companies' pay programs and pay philosophies. Additionally, one Subscriber noted that the timing of ISS's policy development process should be considered in relation to the timing of proxy season for most companies (*i.e.,* early spring). Because changes to ISS policies typically apply to compensation decisions made by the board in the year before the proxy is filed, rather than simply to how company policies are disclosed, then companies should have the ability to review and comment on them before the company's decisions are made on structuring pay arrangements.

A. Engagement in Conjunction With ISS Research Reports

Although the Center's Subscribers found ISS policy outreach somewhat useful (see letter C below), the vast majority of Subscribers (71%) labeled the draft review of ISS's reports for S&P 500 companies "not very useful." The conclusion here is not that companies want ISS to stop providing draft reports. Rather, while receiving draft reports allows issuers the opportunity to correct inaccurate data and learn ISS's perspective on their disclosed pay practices, companies often feel that their own suggestions for how to improve the accuracy of ISS's reports are rarely taken and it is difficult to get basic changes made. This especially applies to characterizations of pay plans that border on an inaccurate reading of the plan.

- <u>Sufficient Review Time Still an Issue</u>. Recognizing that ISS has made efforts to give more advance notice on draft reports, subscribers still mentioned the need for sufficient time to review the ISS report and draft a response. As one Subscriber noted, "If this were provided to us more than 48 hours prior to publication it would be considered very useful, but it's typically provided on Friday evening with publication on Monday." In addition, companies outside the S&P 500 do not receive the report at all and are thus unable to notify

ISS of any inaccuracies until the report has already been published to investors. Investors may not necessarily change their votes based on ISS's initial report, even if a correction is later issued.

- Receptiveness to Changes During Proxy Season. Subscribers also noted that while they value the opportunity to engage with ISS via telephone calls and meetings, the staff is "not very receptive to our input" and the "odds of getting something inaccurate changed appear to be very low." While the responses were close, slightly more companies viewed telephonic and in-person meetings as "not very useful" (43%) than "somewhat useful" (38%).

B. Usefulness of a "Preview" of ISS's Company-Related Data

The majority of our Subscribers (77%) indicated that it would be very helpful to them to receive a preview of ISS's data, without vote recommendations, one or two weeks in advance of the full research report. This assumes, at a minimum, that companies would have a chance to review this data for inaccuracies prior to its being published to investors, similar to the current process followed for review of draft reports for S&P 500 companies. Neither companies nor investors would be served by a preview process in which investors are given data which has not been reviewed for accuracy by companies.

If implemented as outlined above, this would help eliminate much of the "last-minute scrambling" companies experience through the current process, but would only be helpful if company feedback is considered in good faith. In addition, this should not replace the preview of the entire report. Because ISS has engaged in a more qualitative review of the company's executive compensation program (and overall this is a positive development), how those plans are characterized can significantly affect how investors analyze company plans. ISS should provide both an early view of the data to mitigate inaccuracies and, as it currently does, an opportunity to review the characterizations of the plan, even if that is within a shorter time frame.

C. Outreach and Engagement on Annual Policy Development and Revisions

As noted above, on the whole, Center Subscribers found ISS's outreach and engagement activities with respect to its annual policy development process "somewhat useful." This reflects the fact that companies appreciate the opportunity to provide their views for consideration on the policy survey and in the comment period for proposed policies. Of all the engagement opportunities, our Subscribers particularly liked the opportunity to participate in roundtable discussions, where their views could be communicated directly to ISS in an off-the-record forum, outside of the pressures of proxy season.

While most Subscribers indicated that the annual policy survey and, to a lesser extent, the comment period on draft ISS policies were "somewhat useful," several noted that comments from issuers do not seem to be given an appropriate amount of weight, despite the fact that it is their disclosures being reviewed. To this point, we find it worthy to note that for the past two years, more corporate issuers have responded to ISS's policy surveys than institutional investors: in 2011, 197 issuers responded versus 138 investors, and in 2010, nearly 700 issuers responded versus 201 investors (only 15% of ISS's client base).

Separation Payments (Question 22)

As we have articulated on past surveys and in our comments on draft policies, the Center believes that if properly constructed, severance can play a valuable role in helping to protect the interests of companies while also providing sufficient protection to the executive to attract the necessary level of talent. Severance arrangements should be clearly disclosed in proxy statements, and they should be structured to reinforce leadership development and succession, as well as the impact of executive stock ownership.

This survey question, which asked whether respondents consider separation payments to be problematic in a variety of circumstances, was headed "Pay for Failure" and began with an observation that "during the past decade, shareholders have witnessed a series of CEOs who have received sizable termination packages at a time of significantly lagging shareholder returns." Framing the question in this way appears to encourage answers in the positive; a more neutral presentation of the topic would seem to garner more accurate and objective feedback. Further, the question blurs the lines between true severance and other forms of payment made upon termination, which makes it difficult for companies to answer clearly and for the results to be interpreted accurately. If ISS's intention is to draft a policy which states that severance should be directly reflective of shareholder returns of the company, it would perhaps be clearer to simply state that outright.

The vast majority of Center Subscribers (95%) responded that cash severance exceeding 3x base salary and target bonus would be viewed by them as problematic. However, other factors are much more situation-dependent and require a nuanced view. For example, a severance settlement when an executive is stated to be retiring or resigning may seem problematic in some situations. However, as several Subscribers pointed out, the actual circumstances of an executive's termination often differ from what is made public, in order to smooth a transition and minimize impact to the business. For the purposes of confidentiality, an involuntary termination initiated by the board may be presented publicly as a retirement. In this case, severance may be paid appropriately to protect the interests of the company as well as the executive. This serves the purpose of facilitating a smooth transition while minimizing embarrassment to the company and executive and mitigating risk to the business of unnecessary upheaval.

Many Subscribers also noted that considering pension payouts as severance is illogical in that most of these are already earned, calculated according to standard plan provisions, and fully disclosed in proxy statements.

Executive Compensation and Sustainability (Question 25)

Following a growing trend of attention to the adoption of compensation metrics which are tied to environmental and sustainability-related performance, this question asked respondents to indicate their organizations' view on the topic. The majority of Center Subscribers (70.5%) believe that the decision to use environmental or other sustainability-related metrics should be left to the judgment of the compensation committee. As one Subscriber stated, "Non-financial metrics of any sort should be determined based on company strategy within the context of delivering long term shareholder value. They should not be artificially imposed by external organizations."

Conclusion

The Center On Executive Compensation appreciates the opportunity to submit its views on the 2012-2013 policy process and welcomes the chance to provide the corporate perspective on ISS's policies. Please do not hesitate to contact me at tbartl@execcomp.org or 202-789-8692, if you have any questions about our comments or would like to discuss them further.

Sincerely,

Timothy J. Bartl

President