November 7, 2011

VIA EMAIL

Dr. Martha Carter
Chair
Global Policy Board
Institutional Shareholder Services, Inc.
2099 Gaither Road
Rockville, MD 2085-4045

RE: Center On Executive Compensation Comments in Response to 2012 Draft ISS Policy Changes

Dear Dr. Carter:

The Center On Executive Compensation ("Center") is pleased to submit its comments on Institutional Shareholder Services, Inc.'s ("ISS") 2011-2012 draft policy changes on behalf of its Subscribers. The Center continues to believe that direct engagement by companies and the entities that represent them will enhance ISS's policy development and improve the dialogue among all stakeholders on executive compensation and related corporate governance issues. The Center has several concerns with and suggestions for improving ISS's proposed policy changes to its pay for performance and say on pay analyses, which we discuss below.

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 330 large companies, and the Center's more than 90 subscribing companies are HR Policy members that 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. Consistent with the Center's mission, our comments and survey responses are focused on ISS's policy changes regarding executive compensation and related governance issues.

A. New Pay for Performance Methodology (Management Say-on-Pay)

The Center believes that a balanced evaluation of pay for performance over the long term should be an essential element of the assessment of executive compensation, but disagrees with the approach taken in the proposed ISS "relative alignment" analysis because it does not measure pay and performance over the same time periods. The Center also believes, consistent with a growing acceptance by institutional investors and issuers, that the most appropriate approach to analyzing pay for performance in the era of mandated say on pay is to compare the amount of pay realized in a year with the performance that generated it. In addition, under the proposed policy, ISS needs to clarify how it will determine what is strong, satisfactory and weak alignment between pay and performance. The following sections provide the Center's comments with respect to the relative alignment test, absolute alignment test and the qualitative analysis ISS will undertake in the event it determines alignment is weak.

1. Relative Alignment Test

Under the first prong of ISS's pay for performance analysis, the relative alignment test, the Center is particularly concerned that the proposed policy fails to compare pay actually realized to the performance period on which it is based. In addition, despite improvement in attempting to measure the link between pay and performance over the long term, the relative alignment test overemphasizes short-term pay for performance.

In prior years, if one- and three-year TSR were below the peer group median and pay was flat, there was a presumption that pay and performance were not aligned. Although ISS performed a qualitative analysis at that point, in many cases, the comparison to the peer group median acted as an "on/off switch" that frequently led to a recommended vote against the company's say on pay plan. The Center urges ISS to be more nuanced in its relative pay alignment analysis under this new approach, such that if pay is commensurate with performance relative to a comparable peer group over similar time frames, pay and performance should be considered aligned.

Peer Group Determinations. ISS has indicated that it is considering expanding the peer group used in its pay for performance determination from eight to 12 companies to 14-24 companies and changing its peer company selection process. Because the peer group determination is central to the relative alignment test, it is essential that the ISS peer group determination be as representative as possible of the companies against which the company actually competes against for products, talent and/or capital and reflect the scope of the company's operations. It is also essential that companies have a clear understanding of how the ISS peer group was chosen.

The Center supports the expansion of the number of peer group companies, but is troubled that the companies selected apparently will be based primarily on GICS codes when there are other, more accurate approaches available to select appropriate peers. These include determinations based on size, industry and other factors such as competitiveness for talent. Recent studies indicate that size is the most relevant factor for determining peers, and GICS code-based peer groups have often produced anomalous results for large companies. Further, two recent reports by Equilar and ISS Corporate Services indicate that, in general, S&P 500 companies have selected peers that are similarly sized or smaller than the company.[1] The ISS GICS methodology has often resulted in a peer group list for large companies that included much smaller companies that are not comparable based on size, scale, scope, market capitalization, and competition for talent.

For example, one Subscriber notes that the companies in its six-digit GICS code have average revenue of about $1.5 billion, while the Subscriber company's revenue is over $25 billion. It is difficult to see how an evaluation using the six-digit GICS code without adjustment would yield an accurate assessment of the company's pay plans. Other Subscribers that are among the largest in their industries have noted that if they used their current ISS peer group and applied the relative alignment test literally, the result would not reflect the company's size, scope or complexity.

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[1] EQUILAR, INC., AN ANALYSIS OF PEER GROUPS AT S&P 1500 COMPANIES 16 (2011); ISS CORPORATE SERVICES, EXECUTIVE PAY THROUGH A PEER BENCHMARKING LENS 6 (2011).

The Center recommends that ISS move away from a GICS-dependent peer group determination to one that is based upon size, competition for products and talent, as well as scope of operations and industry. Based on the research cited above involving large companies, we believe that ISS should use the company's disclosed peer group as the basis of its analysis and make adjustments to that list. Further, ISS should clearly explain its process for determining peer groups under its revised system.

<u>ISS Should Clarify the Definition of Total Pay Under the Relative Alignment Test Before Finalizing Policies</u>. ISS has proposed a relative alignment test involving a comparison of the company's one- and three-year total shareholder return ("TSR") to peers and the CEO's total pay rank to peers. However, ISS has not defined how pay will be defined under this new test. For example, will total pay be defined as it was in 2011[2] and generally follow the Summary Compensation Table calculation (with certain exceptions, including the assumptions used in calculating the accounting value of equity compensation that have resulted in several glaring discrepancies) or will ISS revise its definition for 2012? ISS should clarify this definition prior to finalizing its policies so that issuers and investors may provide comments before its 2012 policies are finalized. The comments that follow presume that ISS is using the same definition of total pay as it did in 2011.

<u>If ISS Continues to Use the Grant Date Value of Equity Compensation, It Should Use the Valuation Disclosed by the Company</u>. It was recently noted that ISS had decided not to revise its methodology for calculating the grant date value of equity compensation. This methodology often varies considerably with the assumptions companies use under Generally Accepted Accounting Principles. In fact, in some cases, the ISS valuations of stock options were double those of the company. The Center believes that to be consistent, if ISS continues to use the grant date value of equity for its pay for performance comparison, it should use the valuation adopted by the company in determining whether to vote for or against an equity plan or a say on pay resolution.

<u>Relative Alignment Test Should Compare Actual Pay and Actual Performance</u>. ISS notes that its new relative alignment policy is intended to show whether a company has demonstrated "pay for performance alignment over sustained periods." The Center believes that ISS should compare pay actually realized by a CEO to the performance that generated it so that consistent time periods for pay and performance are being compared. This approach would give a more accurate view of how a company actually performed relative to peers, because most compensation committees grant equity compensation as an incentive to induce future performance, rather than an award for past performance. The retrospective view is also consistent with the fact that say on pay is a retrospective vote on the company's pay and performance as disclosed in the most recent proxy statement. Good examples of this analysis can be seen in the 2011 proxy statements for Eaton Corporation and International Paper.

The ISS proposed policy uses a measure of pay that combines compensation actually paid in the form of salary, bonus, annual incentive and long-term non-equity incentive plan compensation with the accounting estimates of equity compensation. Moreover, rather than comparing each form of pay to the measure of performance it was intended to generate (e.g., financial measures for the annual incentive), the ISS comparison uses only total shareholder

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[2] *See*, *e.g.*, ISS 2011 Compensation FAQs, *How Is Total Compensation Calculated?*, http://www.issgovernance.com/policy/2011/USCompensationFAQ (last visited Oct. 31, 2011**)**.

return, which does not provide a good comparison of pay for performance over short time periods. The shortcomings with a TSR-only approach were referenced by the SEC in adding the Compensation Discussion and Analysis in its 2006 revision of proxy disclosures and moving the stock price performance chart. The SEC noted that the change was intended to "allow broader discussion than just that of the relationship of compensation to the performance of the company as reflected by stock price."[3] In those cases where TSR is the sole performance metric for a long-term award, it is the appropriate basis of comparison. However, where elements of incentives are based on other performance criteria the Center believes that ISS should compare pay versus the performance that generated it, rather than comparing pay exclusively to TSR.

In addition, the ISS calculation of pay includes the actuarial increase to the pension value, which in the vast majority of cases, is exclusively dependent upon fluctuations in long-term interest rates and has nothing to do with compensation actually paid to a CEO. We do not believe that the increase in pension value should be included in the calculation of total compensation for this reason. However, for consistency, if ISS is going to include this amount in its pay for performance analysis, then ISS should also subtract the actuarial value of the decrease in pension costs when interest rates rise.

The Center acknowledges that institutional investors want and deserve an analysis of the grant date value of compensation for purposes of making future investment decisions. However, we believe that this approach is not appropriate when making a retrospective say on pay vote.

<u>If Grant Date Value of Equity Is Used, the More Appropriate Comparison Is to TSR in Prior Fiscal Year</u>. If ISS chooses to continue its approach of conducting its relative pay analysis by comparing total pay as disclosed in the Summary Compensation Table to TSR, an approach we continue to believe is flawed, the Center believes that the TSR value used should be from the end of the fiscal year preceding the reporting year. Most companies grant equity-based compensation within two and a half months of the close of the prior fiscal year. For this reason, the grant date value should be compared to TSR in the year before equity incentives are granted, since the compensation committee would not have known the TSR in the year compensation was granted until the end of the company's fiscal year after the grant was made. Our recommended approach maintains alignment of compensation and the performance on which it is based. In sum, the Center does not believe that pay based on grant date value should be the basis of comparison, except in those cases where equity compensation is granted as a reward for past performance, such as is the case for many companies in the financial industry. However, if ISS chooses to pursue this approach, then the prior year's TSR should be used.

<u>Relative Alignment Test "Double-Counts" Short-Term Pay and Performance</u>. ISS has proposed to compare one-year TSR against one-year total CEO pay (weighted 40 percent) and three-year TSR against CEO pay over three years (weighted 60 percent). While the Center supports a longer term view of pay versus performance, it believes that the analysis proposed by ISS puts too much weight on the one-year pay for performance measurement because both the most recent year of pay and performance is counted under both the one-year and three-year TSR/pay comparison. The Center believes the more appropriate comparison would be to compare TSR/pay over one year and over years two through four. For example, for the most recent year, assuming a calendar year company, the comparison would be:

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[3] Sec. Exch. Comm'n, Executive Compensation and Related Person Disclosure, Release Nos. 33-8732A, 34-54302A, 71 Fed. Reg. 53,157, 53,168 (Sept. 8, 2006).

Short-term: TSR versus pay between 1/1/2010 to 12/31/2010

Long-term: TSR versus pay between 1/1/2007 to 12/31/2009

This approach would take a true long-term focus that provides a better comparison with TSR.

In addition, it should be noted that for some industries, it may be appropriate to measure long-term performance over a longer time horizon, while in other industries a more traditional approach to assessing performance and pay may be appropriate.

Comparison of CEO Pay Multiple to Peer Group Median Lacks Standards for Comparison. ISS has proposed to compare the multiple of CEO pay to the peer group median "which may identify cases where a high performing company may nevertheless be overpaying." It is unclear whether this is for the most recent year or over both one- and three-years. Either way, it is difficult to identify whether a company may be overpaying relative to peers unless performance is evaluated along with pay. The Center believes that a realized pay analysis would address this issue without requiring ISS to conduct additional analysis (assuming that it adopted a realized pay analysis). At a minimum, ISS must articulate how, on a case-by-case basis, it will use the pay multiple to peers to determine overpayment.

The Center believes that to be complete, ISS should also note situations where a company has:

- underperformed peers and overpaid a CEO;
- underperformed peers and underpaid a CEO; and
- outperformed peers and underpaid a CEO.

Such information would be very useful to investors in assessing the strength of the pay program as well as issues such as retention of the senior leadership team.

2. Absolute Alignment Test

ISS has proposed to measure the long-term alignment between pay and company performance by reviewing the difference between the slope of annual pay changes and the slope of annualized TSR changes during the most recent five-year period. ISS must provide greater clarity regarding how this analysis will be conducted and specify what is considered good alignment versus bad alignment so that investors and issuers alike can assess its approach. Will the alignment differ for companies in different stages of their life or product cycle? In different industries? Of different sizes?

Five Years Should Mean Five Years. ISS needs to clarify whether its comparison of five years' performance based upon TSR to five years of CEO pay will actually mean five full years of performance or only four years, as ISS has used in its 2011 reports. For example, in its 2011 reports, ISS did not measure actual TSR for 2006. Instead, it assumed that the TSR index at the end of 2006 was 100, meaning that only four years of actual TSR (2007, 2008, 2009, and 2010 were captured). If ISS wants to compare five years of pay versus five years of performance, it should include a full five years of TSR comparison in its absolute alignment test.

New CEO Exemption Should Continue to Apply. In addition, the Center believes that ISS must give careful consideration to how this test will be applied in situations where a company has a new CEO. The Center believes that the test should not be applied until a CEO has been in place for at least two years, but that still leaves questions regarding whether and how ISS will conduct a five-year analysis for CEOs with less than five years of experience and the impact on the weighting between the relative and absolute alignment tests.

3. Weighting of the Relative and Absolute Tests

ISS notes that the relative and absolute tests "may be weighted 50/50 in this portion of the analysis," but it does not explain when the weighting may shift or how the relative alignment and absolute alignment tests will be evaluated and scored. Because ISS has a significant influence over institutional voting, typically between 20 and 30 percent for most companies, it is important that these issues be addressed well in advance of proxy season.

4. Qualitative Review

The Center believes that ISS needs to provide clearer guidance as to when a company may be deemed to have weak alignment between pay and performance and thus may be subject to a qualitative review. The Center also urges ISS to include as an explicit element of the qualitative review a comparison of the company's pay structure and levels to business strategy, which should be the touchstone of a well-constructed compensation plan. For example, this is especially important for companies that are in a turnaround mode and may have a large grant date value of equity incentives that are designed to incentivize the management team to achieve significant structural changes to enable future growth.

B. Say on Pay

The Center is concerned that the new ISS policies are overly broad and inconsistent with the nonbinding nature of the management say on pay vote as set forth in the Dodd-Frank Act.

The ISS-proposed policy for say on pay provides that if a company received "significant opposition" on its say on pay vote in 2011 and the company failed to respond adequately, ISS would make a case-by-case determination to vote against compensation committee members and, in certain situations, the full board of directors. The Center believes that significant opposition should be defined as failing to receive majority support for the company's say on pay vote. We are concerned that ISS will otherwise adopt a subjective standard that, at best, will result in inconsistent determinations and, at worst, will result in say on pay effectively becoming a binding vote.

The Center also believes that ISS has gone too far in requiring specific, rather than general disclosure of "outreach efforts to major institutional investors as well as concrete actions that [the company] has taken or will take." The Dodd-Frank Act already requires companies to disclose the impact of the say on pay vote on their pay decisions in the next annual proxy statement. Under the proposed policy, ISS is now taking that requirement one step further and asking companies to disclose even more information than is appropriate given that engagement is best achieved between companies and each institutional investor, rather than as a group. As long as the company discloses that it has engaged in outreach to its largest investors, ISS should view that disclosure as satisfied.

C. Say on Pay Frequency Vote

The Center is also concerned that the draft ISS policy would essentially convert the nonbinding nature of the frequency vote into a binding vote since ISS has indicated that it will vote against the company's pay program and all incumbent directors at companies that do not follow the frequency selected by the majority of shareholders. Given ISS's influence in the marketplace, the ISS policy would likely have the effect of making the frequency vote binding, even though under the law, boards have the discretion to select any frequency they determine is appropriate. One obvious result is that the ISS policy will cause companies to hold frequency votes more often than the every six years as permitted under the statute.

The Center continues to be concerned about the impact of the timing disconnect created by the annual say on pay vote, and we believe that in time, say on pay votes will increasingly happen less frequently than annually. This is because the say on pay vote is on the previous year's compensation disclosures, but the vote typically occurs *after* compensation committees have made their decisions for the current year. Thus, companies reacting to a negative or low positive say on pay vote in 2011 will not be able to make changes until 2012 that will be disclosed until the 2013 proxy. Aside from increasing disclosure, as companies will have to discuss the disconnect in their proxies, it may have the effect of causing companies to change compensation practices, including delaying equity grant practices until later in the year.

D. The Need for Analyst Education and Proficiency

ISS has proposed to make its standards more flexible, which could be more reflective of how companies make decisions. Based on its Subscribers' experiences in previous years, the Center is concerned that ISS's permanent and contract staff will not be prepared to analyze and understand the nuances in pay and performance, as well as compensation design, in the new paradigm. We urge ISS to redouble its education and training regime to minimize inaccuracies and flawed analyses so that the best information is transmitted to institutional investor clients as possible.

Conclusion

The Center On Executive Compensation appreciates the opportunity to submit its views on the 2011-2012 policy process and welcomes the chance to provide the corporate perspective on its policies. Please do not hesitate to contact me at tbartl@execcomp.org or 202-789-8692, if you have any questions about our comments would like to discuss them further.

Sincerely,

Timothy J. Bartl

Timothy J. Bartl
Senior Vice President and General Counsel