CAPflash
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Comments on ISS' Draft 2013 Proxy Voting Policies

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Compensation Advisory Partners LLC ("CAP") appreciates the opportunity to comment on the draft 2013 proxy voting policies related to Management Say-on-Pay Proposals and Golden Parachute Proposals.

CAP is a leading independent consulting firm specializing in executive and director compensation and related corporate governance matters. Our consultants have served as independent adviser to Boards and senior management at many leading companies in the areas of compensation strategy and program design, and share ISS' interest in promoting sound corporate governance principles.

MANAGEMENT SAY-ON-PAY PROPOSALS (U.S.)

ISS will vote against advisory votes on executive compensation if there is a perceived misalignment between CEO pay and company performance under the methodology ISS uses for pay-for-performance analysis for companies or the company maintains significant problematic pay practices. ISS is considering the following policy changes for 2013:

1. Use a company's selected peers as an input to its peer group selection methodology, while maintaining an approach that includes company size and market capitalization constraints

2. Potentially incorporate a comparison of realized pay to grant date pay as part of the qualitative evaluation of pay-for-performance alignment

3. Add pledging of shares as a factor that may lead to negative recommendations under the existing problematic pay practices evaluation

ISS REQUEST FOR COMMENT – PEER GROUP SELECTION

Are there additional or alternative ways that ISS should use the company's self-selected peer group to inform its peer group construction?

CAP Perspective: *We believe it is a positive step for ISS to expand its formulaic peer selection methodology to better take into account each company's self-selected, Board approved peer group. By using an 8-digit GICS resolution and incorporating the GICS groups represented in the subject company's peer group, ISS peer groups will increase the degree of overlap between the ISS peer groups and the subject companies self-selected peer group(s).*

We encourage ISS to further acknowledge the importance of pay comparisons that use a subject company's disclosed peer group. We believe that it is important to use a consistent peer group for both pay benchmarking and for performance comparisons. In contrast, ISS noted that "these peer groups are designed not for pay benchmarking…, but rather to compare pay and company performance." Further, we believe that understanding of a company's self-selected peer group is material to understanding each company's compensation decisions. Given this, we suggest ISS include results of its formulaic pay-for-performance tests (RDA / MOM / PTA) for its peer group side-by-side with each company's disclosed peer group.

Since company size is highly correlated with levels of executive pay, what is a reasonable size range (revenue/assets) for peer group construction?

CAP Perspective: *We agree that ISS' current screening criteria for revenue/assets (0.45 – 2.1x subject company) is reasonable, but we believe that the current approach continues to be too formulaic. ISS should allow for a limited number of peer companies (e.g., up to 20%) to range up to 3x of subject company revenue/assets, if these companies are in the company disclosed peer group.*

Are there additional factors that investors should consider in peer group construction for pay-for-performance evaluation?

CAP Perspective: *We believe that more weight should be placed on the subject company's business model, even if this is done in a qualitative fashion. One of our clients manufactures consumer durable products and the ISS selected peer group is dominated by home-builders. Another client sells luxury branded products and is compared to sellers of undifferentiated low price-point merchandise. The result is a loss of credibility for ISS, since many peer companies are a poor fit in terms of business model.*

ISS REQUEST FOR COMMENT – REALIZABLE PAY

How would you define realizable pay?

CAP Perspective: *ISS currently uses the compensation reported in the annual proxy statement (modifying option grant date values to reflect the full option term, rather than the expected life of the options) for its quantitative pay-for-performance tests. For realizable pay, we suggest the following definition:*

1. 3-year average cash or cash equivalents, including Salary, any discretionary Bonus, Non-Equity Incentive Compensation (including annual and long-term cash incentive payments), Change in Non-Qualified Deferred Compensation and Pension, and All Other Compensation; each as disclosed in the Summary Compensation Table; plus

2. 3-year average intrinsic value of Stock Options granted during the 3 year period, valued based on the ending stock price; plus

3. 3-year average value of restricted shares, RSUs and performance share units granted during the 3 year period, each valued based on the ending stock price. If disclosure clearly indicates the number of performance shares actually earned, this value would be used. Otherwise the target number would be incorporated in the calculation.

The resulting value could be compared to "grant date" pay and also relative to other companies. We recognize that this is not a perfect solution, but we believe it reasonably responds to the issue of measuring realizable pay without adding undue complexity to the calculations. For example, the 3-year period corresponds to the disclosure contained in one proxy statement. We acknowledge that 3 years is a relatively short period to assess a stock option with a 10-year term, but believe it to be acceptable since the comparisons are done relative to peer companies measured during the same 3-year period and this value most directly relates to shareholder experience during the performance period being reviewed.

We are pleased that ISS has recognized the trend to focus on realizable pay rather than "grant date" pay when Committees assess a pay-for-performance relationship. However, we are disappointed that ISS only plans to use realizable pay as part of its qualitative assessment, if triggered by below par quantitative results. We urge ISS to make broader changes to its approach, by incorporating realizable pay in the Pay-TSR Alignment (PTA) test. We believe realizable pay should be used in the PTA test since realizable pay is more closely aligned with absolute shareholder returns than a construct where pay reflects the grant date value of stock options and equity awards.

Should stock options be considered based on intrinsic value or Black-Scholes value, and what is the rationale for your choice?

CAP Perspective: *When analyzing realizable pay, we urge ISS to consider the intrinsic value of stock options. This directly ties compensation value with performance (in this case TSR / shareholder wealth creation). In contrast, a Black-Scholes value would include valuation related to the time value of money over the remaining term of the option. Moreover, we believe all inputs to the realizable pay analysis should be accessible from compensation amounts disclosed in annual proxy statements. This would not be the case with a Black-Scholes valuation which would require additional calculations and agreement on assumptions for volatility and expected life, among other factors.*

What should be an appropriate measurement period for realizable pay? One year, or three years, or five years or others?

CAP Perspective: *We believe the appropriate measurement period for realizable pay is three years. This period strikes the right balance between accuracy and efficiency, since it can be calculated with the information provided in a single proxy statement.*

ISS REQUEST FOR COMMENT – OTHER

Please feel free to add any additional information or comments on the proposed policy change.

CAP Perspective: *We have additional comments that relate to ISS Say on Pay vote recommendations. Outlined below, we describe additional changes that we urge ISS to consider related to: a company's response to its Say on Pay shareholder support level; how ISS measures TSR for the quantitative CEO pay-for-performance assessment; ISS' policies around the rigor of performance goals; and how ISS treats multi-year long-term incentive grants.*

BOARD RESPONSE TO SAY-ON-PAY VOTE

We believe that when a high percentage of shareholders, for example, 90% or more, support a pay program, little or no year-over-year change should be expected. Therefore, we urge ISS to add to its qualitative assessment of the pay-for-performance relationship a review of prior shareholder support for the Say on Pay resolution. Given 90+% shareholder support and no substantial program changes year-over-year, ISS should recommend shareholders support a Say on Pay resolution in the subsequent year.

Alternatively, when a company receives less than 70% shareholder support for Say on Pay and pay program change is expected by ISS, we urge ISS to recognize the typical compensation program decision making calendar. For example, when Compensation Committees make final executive compensation program design decisions for the upcoming year, usually in the first quarter, they will not yet have results of the Say on Pay vote. In these instances, we urge ISS to focus on changes to compensation program design that will occur the following year as disclosed in the text of the CD&A, rather than Summary Compensation Table disclosure that reflects actions taken prior to knowledge of Say on Pay support level.

TSR MEASUREMENT

In line with the methodology used for SVT calculations, we urge ISS to use an average stock price at the beginning and end points of the TSR calculations used in its pay-for-performance test. Use of a 20 trading day average stock price would limit the impact of very short-term price fluctuations on the results.

PERFORMANCE GOALS – EVALUATION OF "RIGOR"

ISS reviews the rigor of performance goals in its qualitative pay-for-performance assessment. It would be helpful to better understand the parameters for this assessment.

MULTI-YEAR LONG-TERM GRANTS

When recruiting new CEOs, companies often grant long-term incentives that are intended to make up for compensation forfeited from a previous employer (often called "make-whole" grants). In these instances, we encourage ISS to exclude these grants from the pay-for-performance testing since the grants fill a very specific need and would not be granted in the absence of forfeited compensation.

In other situations, companies make multi-year grants (sometimes called "special" or "retention" grants). These awards are not granted annually. Instead a larger grant is made up-front, followed by a period where grants are smaller or not made at all. In these cases, the amounts disclosed in the Summary Compensation Table and Grants of Plan Based Awards Table reflect the full-value, but companies view these awards as applying to multiple years. We urge ISS to annualize such grants in their analysis, and believe it would be a more accurate representation of long-term compensation. The value of the award could be readily annualized over its vesting period. ISS could also limit the number of years over which an award could be annualized (e.g., over no more than three years).

ISS REQUEST FOR COMMENT – PLEDGING OF COMPANY STOCK

ISS is considering adding pledging of company stock to the list of problematic pay practices that may result in an adverse vote recommendation. ISS noted that pledging of company stock as collateral for a loan may have a detrimental impact on shareholders if the officer is forced to sell company stock, for example to meet a margin call. Alternatively, when done prudently, hedging can provide flexibility by allowing executives access to lower cost financing without having to sell company stock to fund other purposes. The key here is balance. Excessive leverage is never a good thing and to the extent that executives do pledge shares certain safeguards should be in place.

What would you consider a "significant" level of pledging of company stock that causes concern for investors?

CAP Perspective: *We would consider a significant level of pledging of company stock that causes concern for investors to be an amount where the stock price could be impacted by the sale of the shares. We believe pledging of shares with a value that exceeds 5 percent of the company's market value should be considered significant.*

In addition to the potential impact on stock price, investors could be concerned if a margin call forces a sale, particularly during a period where the trading window is closed. This could be prevented by requiring the executive to attest that other liquid assets, unrelated to company stock, are readily available to satisfy any potential margin call. Finally, stock ownership guidelines and policies prohibiting hedging should be in place to ensure that the executive remains invested in the company stock, even while pledging a portion of shares owned.

If pledging raises concerns significant enough to warrant voting action, should this action be directed at the (i) management say-on-pay proposal (if available), (ii) the board, or (iii) members of one of the board committees (e.g., Audit, Governance, Compensation – please specify)?

CAP Perspective: *If pledging of shares is significant enough to warrant remedial action and ISS plans for this to influence its vote recommendations, we urge ISS to direct their concern regarding pledging to the Say on Pay vote. Pledging would be ad-*

dressed by company policy akin to related issues, such as stock ownership guidelines, which are best reflected in the Say on Pay advisory vote.

Would you consider a company's remedial actions on pledging (such as a commitment not to pledge in the future, commitment to unwind their positions within a reasonable period) sufficient to address concerns?

CAP Perspective: *Yes, we urge ISS to consider a company's remedial actions on pledging sufficient to address concerns. These positions may require time to unwind. Given the timing of the updated policy release, we hope that ISS considers the complexity of companies trying to align themselves with ISS policies.*

Are there additional factors that investors should consider for the case-by-case analysis?

CAP Perspective: *Yes, we believe there are additional factors investors should consider for the case-by-case analysis. One factor is a disclosed trading policy that prohibits hedging, that is short-selling and derivative positions, which potentially immunize an executive against exposure to company stock. A second factor is a policy on stock ownership guidelines. The third factor is limits on the amount pledged expressed in terms of the total shares relative to the company's capitalization and to the executive's total position.*

SAY ON GOLDEN PARACHUTE PROPOSALS (U. S.)

ISS is proposing to update the policy on Golden Parachute proposal to:

1. Include existing change-in-control arrangements maintained with named executive officers rather than focusing only on new or amended arrangements.

2. Place further scrutiny on multiple legacy problematic features in change in control arrangements. When the Golden Parachute vote is incorporated into the advisory Say on Pay vote, ISS will evaluate the Say on Pay proposal in accordance with these guidelines, which may give higher weight to that component of the overall evaluation.

ISS REQUEST FOR COMMENT – GOLDEN PARACHUTES

In your organization's view, when evaluating payments arising from problematic pay practices in the context of a say on golden parachute proposal, would you differentiate between new and existing arrangements when determining whether to support the proposal? If yes, please specify.

CAP Perspective: *Yes, we encourage ISS to differentiate between new and existing arrangements when determining whether to support a say on golden parachute proposal. Often times, existing arrangements are contractual and therefore not quick or simple to modify.*

CAP also encourages ISS to differentiate between the problematic features it identified. Certain features strike us as more problematic than other features. For example, assume that two companies put forward proposals where each had a single problematic feature. Assume that Company A had excise tax gross-ups, while Company B had single trigger acceleration of unvested stock options. We submit that the excise tax gross-ups could result in a material cost to shareholders. In contrast, single trigger equity vesting accelerates the executive's ability to participate in the transaction along with shareholders. A company that has single trigger equity vesting may not be taking a leading edge position on compensation governance issues, but is also not supporting practices that are necessarily unfriendly to shareholders.

Would the number of problematic features be a consideration when evaluating a say on golden parachute proposal? If yes, please specify.

CAP Perspective: *We believe ISS should focus on the potential value of arrangements it views as problematic, rather than a formula driven by a pre-determined number of program features. For these arrangements to justify ISS to consider an Against vote recommendation, ISS should come to the conclusion that potential payments are "excessive." (See below for discussion of 'excessive')*

Are there any other factors that should be considered in evaluating say on golden parachute proposals? If yes, please specify.

CAP Perspective: *Given the timing of the updated policy release, we hope that ISS considers the complexity of companies trying to align themselves with ISS policies. In addition, an ISS defined problematic practice includes: "excessive golden parachute payments (on an absolute basis or as a percentage of transaction equity value)." We urge ISS to clarify their definition of excessive – both in absolute terms and as a percentage of transaction equity value – as it is difficult for companies to comply with a policy without specifics.*

CAP is submitting commentary on its own behalf and not on behalf of any specific clients.