

Proposed Pay-for-Performance Rules

As We See It: Commentary to the Securities and Exchange Commission (SEC) should urge modification of the proposal to require narratives which are more tailored, thoughtful and better align pay and performance.

Five years following enactment of the Dodd-Frank Act (DFA), the SEC has issued a controversial proposal implementing Section 953(a), the pay-for-performance (PFP) mandate. The proposal is laden with ambiguities and seeks comment and suggestions on over 60 significant topics. We have discussed our most significant concerns with our clients, and while not all opinions were universal, we have produced this AWSI that reflects collected thoughts. A more detailed letter reflecting our extensive feedback and comment will be submitted to the SEC by the July 7 deadline. To the extent that any views are aligned with ours, we welcome reiteration of our thoughts to the SEC.

A Principles-Based Approach Is More Meaningful And Helpful For Shareholders

We believe that the SEC could have implemented Section 953 by allowing companies more flexibility to communicate how their pay is actually tied to their performance on a holistic level. The DFA was enacted in the midst of an unprecedented fiscal crisis, with many targeting excessive pay as the culprit. At that same time, many proxies were devoid of substantive discussions regarding the link between long-term company performance and executive pay.

Fast forward five years and the disclosure landscape has dramatically changed – partly driven by Institutional Shareholder Services (ISS) and other institutional shareholders conducting their own PFP tests, and partly by motivated committees determined to demonstrate the true way in which compensation programs are linked to and drive company performance, whether or not it is measured as total shareholder return (TSR). The importance of enhanced PFP disclosure was further amplified with the enactment of advisory voting on say-on-pay (SOP) which began in 2011.

While five years ago it appeared that companies needed a prescriptive and rigid mandate to demonstrate PFP relationships, this is simply no longer the case. Our clients are already spending considerable time on their disclosures working to show their specific PFP story. This approach allows companies more flexibility and is superior to the proposal's rigid one-

size-fits-all, approach which focuses on backward-looking performance. The current construct of the proposal is a simplistic way of looking at compensation that does not reflect the intent of the compensation committee or the actual results of the compensation rewarded. Moreover, it will put those companies whose pay decisions are not tied solely to TSR on the defensive and will likely result in lengthy disclosures explaining the difference between the mandated disclosure and what is actually relevant to drive company performance – an exercise which provides no benefit to investors and muddles an already long and complicated report. Quite simply, the SEC should have embraced their principles-based mantra by continuing to allow companies to use a flexible approach in providing company-specific PFP narrative to investors.

Realizable Pay Is The Next Best Approach

The SEC rejected a holistic approach on grounds that it did not provide enough comparability across companies, and instead adopted a new “Actual Pay” construct to be used in the PFP disclosure and related table. This new methodology creates yet another way of calculating pay, rejecting the Summary Compensation Table (SCT) total computations, as well as “realized” and “realizable” methodologies which are already deeply embedded and well understood concepts in PFP disclosure discussions. Instead, the proposal uses a hybrid approach which mixes and matches different pay concepts resulting, in most cases, in a misalignment of pay and performance timing.

While we agree that a flexible approach may lack in comparability, we do not believe that the DFA mandates comparability across companies. Nonetheless, if the SEC views comparability as a paramount concern, we believe the next best methodology after flexibility lies in a “Realizable Pay” analysis, which is a superior way to demonstrate the alignment between changes in executive compensation granted and outstanding, and changes in return to shareholders over a period of time. It is also closer to the approach already taken by major proxy advisory firms and therefore one with which companies are already familiar. Using this approach would mitigate the burdens accompanying a brand new disclosure methodology. We would suggest that the most useful definition of pay for a PFP comparison would include the following elements of Realizable Pay, as compared to cumulative TSR over a three- to five-year timeframe (the “Period”):

Pay Element	Realizable Pay
Salary	Actual salary received (same as SCT) during Period
Annual Cash Incentives	Actual annual incentive/bonus earned (same as SCT) during Period
Long-Term Cash Incentives (LTI)	<ul style="list-style-type: none"> ▪ Actual LTI cash granted and paid during Period ▪ Targeted payouts of outstanding awards granted but not yet paid during Period
Stock Options/SARs	“Intrinsic Value” (spread between exercise price and stock price at end of the Period) of options awarded during Period (vested or unvested)
Restricted Stock/RSUs	Value of shares granted during Period (vested or unvested) valued using stock price at end of Period
Performance-Based Stock	<ul style="list-style-type: none"> • Actual awards granted, vested and paid during Period, valued using stock price at end of Period • Target value of awards granted but not yet vested during Period, using stock price at end of Period
Pension	Excluded
Deferred Compensation	Excluded
SCT “Other”	Excluded

We believe that a five-year cumulative look at Realizable Pay and TSR is the most practical approach as it is sufficient in duration to smooth out at least some outliers, and it would cover several overlapping long-term performance awards.

Finally, whether the SEC ultimately adopts the concept of Actual Pay or Realizable Pay or another variant, we do not believe the “new” pay amounts should be accompanied by SCT compensation in the new PFP table. It presents too much information which can be found elsewhere in the proxy, and will provide yet another instance where companies will feel compelled to explain the reasons for differences.

Options Should Be Valued Intrinsically

If the SEC does not use Realizable Pay for Section 953 purposes, we would urge it to at least adopt the Realizable Pay methodology (“in the money” value) for assessing stock options over a period of time. The proposal requires that outstanding stock options be valued as of the vesting date using a new valuation of the option’s fair value (i.e., present

value as determined by the Black-Scholes model or other widely-accepted pricing model). We take issue with both the valuation and timing set forth in the proposal.

Valuations based on a revised Black-Scholes estimate are a function of, among other things, remaining option term, current interest rates, and volatility, all of which are mostly unrelated to company performance. Once an option vests, its true value to an executive turns on an investment decision (i.e., timing of exercise), rather than a Black-Scholes calculation. In addition, under the proposal even if an option is “underwater” at vesting, the fair value must be calculated and added to total compensation thereby including an amount that the executive may never realize. New valuations require a considerable amount of new work and assumptions for options vesting during each year in the new PFP table.

As to timing, an approach which ties value directly to option vesting could result in committees structuring awards to mitigate or game value inclusion. For example, many companies may feel compelled to eliminate cliff vesting or change the timing of vest from December to January in order to allocate value differently in the 5-year PFP table – changes that may or may not support company strategy. In addition, if options are valued at the time they vest – which is typically earlier in the fiscal year – but TSR is measured as of fiscal year-end, yet another disconnect surfaces as stock prices may radically change in the interim.

A better and less costly PFP analysis would isolate stock price movement and directly track it with pay potentially realizable. Valuing stock options granted during a specified period and using their intrinsic value (i.e., based on stock price at end of period) would give shareholders an assessment of changes in realizable pay based upon real movement in stock price and not changes in other factors that may have an impact on the Black-Scholes value. Moreover, the SEC did not seem to seriously consider the cost and time involved in running a Black-Scholes model, which typically requires hiring outside resources and multiple layers of review. In short, we do not believe that recalculating Black-Scholes values is a useful exercise when looking at the relationship of pay and performance, and that intrinsic value is a superior method to use, whether at vesting or over a Realizable Pay Period.

Amendments To Pension Calculations Are Appropriate

While we believe a Realizable Pay approach should exclude any values associated with pensions, the modified pension valuation construct proposed by the SEC is a better methodology than that currently used in the SCT. As noted by the SEC itself, the current SCT value (change in actuarial present value) includes amounts wholly unrelated to performance, the intent of committees, or even the actual pension benefit the executive will receive at retirement. By limiting the definition of Actual Pay to changes in the present value of pensions that are attributable to service over that year, the SEC has taken a positive step to exclude “noise” associated with changes in interest rates, mortality, age, and other actuarial assumptions. We would take this one step further and urge the SEC to adopt this approach for the SCT rules as well.

TSR Is A Good Starting Point But Does Not Tell The Full Story

We agree with the SEC that investors refer to TSR, among other measures, to judge company performance. However, we strongly disagree that TSR should be the sole measure used to demonstrate a company's (or its peers') financial performance over time. Using one performance measure so limited in scope ignores important underlying operating performance measures. Moreover, a point-to-point TSR calculation is distorted when there are unusual lows and highs on the first and last days of the measurement period or if the company is in an industry prone to cyclicalities impacting these measurement dates. Further, under the proposal, TSR may not be adjusted for extraneous factors such as large dispositions of stock for reasons unrelated to performance, share repurchase programs, and pending acquisitions, spin-offs, etc. Even worse (and as noted by Commissioner Gallagher's dissent to the proposal), relying exclusively on TSR as a performance measure could result in corporate gaming strategies to boost stock price in the short-term. In fact, the SEC anticipates this exact scenario on page 93 of the proposed release where it explicitly states "by virtue of the disclosure, boards may become more likely to approve compensation structures that more strongly link pay to stock price performance, even in situations in which this would not be optimal." An unfortunate but probable unintended consequence of the proposal is the pressure this disclosure will put on committees and boards to adopt annual TSR as the sole or major performance measure in the performance-based compensation elements in the company's executive compensation package.

Given the inherent problems of using TSR as the sole measure of financial performance, we believe it is imperative that any prescribed PFP disclosure rule allow a company to include, side-by-side with TSR data, the **actual metrics** established by the committee to drive performance specific to the company's strategy. Separate column(s) in the PFP table should be allowed so that companies can present performance measures and results actually achieved over the five-year period that were relevant to driving pay. We do not think such critical measures should be buried in optional supplemental disclosures, but rather they should be highlighted to the same degree as TSR.

Peer Group TSR Is Not Mandated And Not Helpful

By the SEC's own admission, Section 953(a) does not require that the PFP rule include Peer Group TSR or a comparison of a company's TSR to such peer group. This is the first time the SEC has required an explicit and formal requirement to compare in a discussion its performance as indicated by a particular performance measure against the performance of some peer group companies. In short, it appears that the SEC has endorsed the ISS pay-for-performance test by adding an additional reporting burden.

Not only is Peer Group TSR not mandated, but we do not believe it is helpful or relevant to understanding a company's PFP relationship, and it should not be part of Section 402(v). Peer group performance is already provided to investors in the Item 201 performance graph and the SEC's attempt to match it up to company Actual Pay is mixing apples and oranges. All companies have different performance cycles and unique nuances that impact

point-to-point stock price, but the current proposal assumes stock prices follow identical patterns across industries and company business cycles. Additionally, a company may be disadvantaged if the peer group constituents' TSRs have benefited from practices that imprudently inflated TSR such as generous but inappropriate dividend distributions.

In short, there is no such thing as a perfect peer group and some companies do not have a sufficient number of appropriate peers to choose from. In fact, an unintended consequence of the proposal may include selection of poor performers in the company peer group in an effort to enhance the appearance of alignment. Some companies are so big that their peer group by its very nature must be limited to other large companies which are often outside of their industry. It makes no sense to compare five-year point-to-point TSRs of a retail company to those in the oil and gas sector, for example. Moreover, attempts to isolate TSR for management performance and ignoring the impacts of different industry cycles, leverage, liabilities, and workforces is illogical and will produce nonsensical comparisons.

If the final rules continue to mandate Peer Group TSR disclosure, we would urge the SEC to allow companies to use multiple peer groups in the PFP Table (i.e., index, industry and CD&A peer group if they so choose) to smooth out any unaccounted for nuances in Peer Group TSR. In addition, there are several ambiguities where additional guidance should be provided, such as:

- If a company uses multiple peer groups in its CD&A (e.g., one for compensation levels and one for TSR-related performance) may it use either group for purposes of the PFP table? We believe the rules should permit this flexibility.
- If a company uses the peer group disclosed in the CD&A, should it be the most recent peer group or the peer group used for the upcoming proxy upon which the most current year's compensation is based or does the Peer Group TSR need to be updated for each of the five years in the PFP Table? We would suggest the most appropriate peer group should be limited to the most recent peer group.

Only The CEO Belongs In The Analysis

Investors as well as proxy advisors are primarily interested in CEO pay, which typically sets the tone for the company and drives SOP results. We do not think reporting any data for other NEOs over a five-year time period is helpful or even valid information about a company's PFP relationship as there is too much inherent "noise" in the data. Over such a time horizon, there could be dozens of NEOs floating in and out of the proposed PFP table, many of whom either have significant sign-on or termination packages which will completely distort all data, even if it is averaged. Instead, including this data will result in even longer and more complex disclosures as companies try to explain nuances in data, and it will ultimately detract from meaningful discussions that show any PFP relationship between the CEO's pay and company performance, which is the primary investor focus. If the SEC feels compelled to maintain data regarding NEOs, however, we agree that the pay data must be averaged.

We also note that over a five-year period, there's a good chance there will be multiple CEOs or even co-CEOs which, under the current construct, would require companies to aggregate all pay of each individual in the role. Aggregating pay will grossly distort pay in years with multiple CEOs and ultimately require lengthy disclosures explaining the misleading data that is irrelevant to the PFP analysis.

Proposed Reporting Will Show A Misalignment Due To Disconnect Between Pay And Performance Timing Issues

The proposal presumes there is a consistent correlation between pay and TSR performance on a year-to-year basis, which is a false premise. Performance periods and vesting periods are varied, and the performance cycles that vest in any given year are typically based on time periods that will differ from the TSR period to which the payment will correlate. For example, most performance-based stock plans vest over three or more years. The proposal would require reporting of this grant in the year of vest, and compare it to the cumulative TSR results as of that year, which may or may not correlate to the award's performance period. As a result, payout and TSR performance measurement will not match. In addition, as mentioned above, if options are valued at the time they vest – which is typically earlier in the fiscal year – but TSR is measured as of fiscal year-end, yet another disconnect surfaces as stock prices may radically change in the interim. The specific timing of grant and vesting will have an impact on the proposed disclosure, but such disclosure nuances should not be driving committee decisions in structuring strategic compensation packages.

This reporting mismatch will likely mislead and confuse investors more, rather than providing valid insight into the relationship of a company's pay to its financial performance. It will also require added text to explain the disconnect, creating another "mini CD&A" under Item 402(v). Again, we believe that using a Realizable Pay methodology may mitigate some of this disconnect.

A Longer Time Period Is Better Than A Shorter One, But Realizable Pay Over A Cumulative Period Provides A Better Methodology

We agree with the SEC that a more effective approach to demonstrating PFP provides data over a longer period of time, such as the five years suggested in the proposal. However, we disagree that the best way to show the relationship is on a point-to-point annual basis.

A far more practical approach would be to use Realizable Pay over a three- to five-year period, as compared to cumulative TSR over that same time-frame. This approach would mitigate (but not eliminate) some of the misalignment issues discussed above. It would also come closer to the way committees actually think about pay and performance over the longer term.



More Guidance Is Needed For Corporate Transactions

We note that the proposal is devoid of guidance pertaining to situations where a merger, acquisition, spin-off, or other change in corporate structure impacts TSR and who may be an NEO before, during, and after the transaction. For example, should the NEOs prior to a transaction for both companies be included post-transaction? Should multiple CEOs coming in from both companies be aggregated? Would companies only show compensation and TSR for the successor company and, if so, how would this relate to NEO compensation paid to target NEOs prior to the transaction?

Newly Public Companies Should Have A Longer Transition Period

Under the proposal, companies that have had a recent public offering (IPO) only need to report PFP data for years in which they are publicly-held. We believe there should be a phase-in period of at least three years following an IPO because one year of TSR and pay data for a newly public company provides meaningless information. We also believe that pre-IPO awards should be excluded from the computation of Actual Pay.

Smaller Reporting Companies (SRCs) Should Be Exempt

Trying to show a relationship between executive pay and the TSR of an SRC is counter-productive. The TSRs of SRCs are much more volatile than larger reporting companies, as is pay. However, these smaller companies may have recruitment needs and performance-based plans linked to more critical strategic results. It would also require SRCs whose resources are already limited to assemble and explain more data than ever before. Private companies may even be dissuaded from going public based on this additional reporting burden and its consequences.

Any Data Tagging Should Be In Block Form Only

We understand that the requirements of the proposal to tag each data point in XBRL format will cause a tremendous amount of additional work and cost for our clients. We are opposed to this requirement not only due to increased cost, but also because we do not think the data that will be pulled contains any useful information to be used on a comparative basis. It is exacerbating the impact of the bad data caused by “noise” and misalignment discussed throughout, and will not be helpful to investor understanding of compensation programs. If the SEC feels compelled to tag any data, we would suggest that companies simply be able to block tag the entire 402(v) section as a whole, rather than enabling the public to pull unhelpful bits and pieces of information that will simply feed media frenzy.



There Are No Benefits Associated With This Disclosure as Proposed

In speaking with our clients, we understand their views to be that there is no benefit associated with the new mandate either to their investors or employees. Increased compliance costs and burdens on resources will result from the extra work involved in revaluing equity and pensions and gathering data going back five years for dozens of individuals. There will be longer proxies (we envision a mini-CD&A sprouting up following the PFP table), higher printer costs and an inordinate amount of work stemming from new data tagging requirements. The proposed rules will not result in creation of value for shareholders and may serve as a disincentive for some companies to list on a U.S. exchange. Even worse – as we have seen following every new piece of executive compensation regulation – will be the flurry of baseless plaintiff's claims asserting a PFP disconnect.

Proxy firms and investors already have the PFP disclosures they need to make informed decisions, and the new disclosure will detract from the real PFP story, philosophy, and objectives necessary to design intelligent compensation programs.

About Pearl Meyer

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