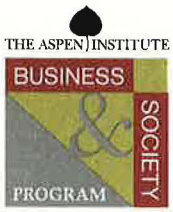

VIA Electronic Submission (rule-comments@sec.gov)
Securities and Exchange Commission
100 F Street, NE Washington, DC 20549-1090

Re: Pay vs. Performance Disclosure - Comments on Proposed Regulations

Concern about an overly narrow and prescriptive approach to "pay versus performance" disclosure

The Aspen Institute's Business & Society Program (Aspen BSP) was established in 1998 and builds on over 60 years of Aspen Institute programming. Specifically, Aspen BSP's Corporate Values Strategy Group (CVSG) is dedicated to re-asserting long-term orientation in business decision-making and investing. Members of CVSG, who include institutional investors and investor representatives, business leaders, scholars of governance and entrepreneurs, share concern about short-term pressures in today's capital markets that result from intense focus on quarterly earnings and incentive structures that encourage corporations and investors to pursue short-term gain with inadequate regard to long-term effects. Disregarding long-term effects constrains the ability of business to do what it does best – create valuable goods and services, invest in innovation, take risks, and develop human capital.

The White House website proclaims that the *Dodd Frank Act: The Wall Street Reform and Consumer Protection Act (Dodd-Frank)* is, "The most far reaching Wall Street reform in history, Dodd-Frank will prevent the excessive risk-taking that led to the financial crisis.... These new rules will build a safer, more stable financial system—one that provides a robust foundation for lasting economic growth and job creation."[i]

Executive pay has long been a topic of interest to Aspen BSP, and today we are writing in response to the request for comments on the proposed rules to implement Section 953(a) of the Dodd-Frank Act relating to pay versus performance disclosure. We recognize that Dodd-Frank addresses the concept of pay versus performance by requiring registrants to disclose in a clear manner the relationship between executive compensation actually paid and the financial performance of the registrant, taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions. The statute provides flexibility around both the format of disclosure and the metrics used. As Representative Barney Frank stated in regard to the purpose of the statute, "We're not trying to dictate to the company [which metrics they should be using]. There are a range of ways to do this."[ii]

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The proposed rule on pay versus performance, however, includes rigid and prescriptive requirements for this disclosure. The proposed rule includes mandatory reliance on the total shareholder return (TSR) of a registrant in an overly simplified tabular format which is potentially misleading and has, in our judgment, strong potential for inducing risky behavior.

Widely documented studies have shown time and time again that TSR, used in the manner contemplated by the proposed rule, works counter to the intent of the statute which is to protect the long-term interests of investors by motivating thoughtful management decisions including planning for future growth and sustainability. TSR reduces a complicated set of drivers and background into one, often misleading, number and is not a predictor of the financial health of a company nor an indicator of whether an executive is taking steps to ensure long-term corporate strength and performance. Moreover, the proposed tabular format will be too narrow to capture the real drivers of long-term performance of individual companies. Absent a narrative discussion of the actual factors driving executive compensation within a company, a table such as the one in the proposed rule could be misleading to all but the most sophisticated of investors. We therefore respectfully suggest that the proposed rule be modified to require a principles-based disclosure whereby registrants may choose how to present the relationship between executive compensation actually paid and the financial performance of the company.

TSR is An Inadequate Metric of Corporate and Executive Performance

After extensive consultation with the investment community, corporate leaders, labor and leading academics, the 2007 *Aspen Principles for Long-Term Value Creation* articulated a sensible principle that corporate executive compensation be aligned with business strategy and long-term metrics and that executives "are compensated largely for the results of actions and decisions within their control, and compensated on metrics of long-term value creation."[iii] We feel the TSR metric fails on both of these dimensions.

TSR performance is affected by a wide range of factors, many of which are beyond the control of a corporate executive. As one recent study stated, "the focus on share price appreciation through total shareholder return (TSR) obscures more than it reveals with share price as a capital markets performance metric. Factors which impact TSR such as fund flows, central bank policies, macroeconomics, geo-political risks and regulatory changes are all beyond the control of executive management."[iv] Indeed, among the many powerful critiques of executive compensation in recent decades has been the recognition that "pay for luck"[v] has been a disturbingly common result of attempts to tie executive pay to financial performance.

TSR is a relative measure of performance against market expectations, not fundamental drivers of long-term company value. Often, TSR performance and a company's fundamental economic performance diverge dramatically. Van Clieaf and O'Byrne found that, "Only 35% of S&P 1500 companies generated both five-year positive relative TSR and five-year positive cumulative economic profit (ROIC exceeding cost of capital)."[vi] A tangible example is Microsoft. Between 2000 and 2010, Microsoft's revenue and profits nearly tripled, while its stock price traded between $20-$30 for the decade.[vii]

When used as a primary metric of executive performance, TSR can create a number of perverse incentives. For well-run companies, high expectations for future performance are often already priced

into their valuation. Tim Koller, Richard Dobbs, and William Huyett of McKinsey remind us of the adage that, "Good companies may not be good investments because future great performance might already be built in to their share price."[viii] Because high expectations are already built into their stock price, management of these firms may perform quite admirably by simply meeting these high expectations. But simply meeting high expectations will not increase TSR. In order to *increase* TSR, leaders of good companies must *exceed* already high-expectations -- a goal that in some instances may only be achieved by taking on irresponsible and unwise risk or employing aggressive accounting tactics.[ix] This outcome runs counter to the intent of Dodd-Frank.

On the other hand, poorly run companies will often have very low expectations built into their current stock price. Even marginal improvements to a business may produce TSR outperformance relative to well-run, high-expectation companies. As Koller et al note, "smart investors often prefer weaker-performing companies because they have more upside potential, as the expectations are easier to beat."[x] Relying on TSR to determine the performance of a CEO at a low-expectation company is therefore also problematic. It gives preference to leaders of companies with low expectations over leaders of companies with high expectations and creates an unusual incentive for corporate leaders to keep stock market expectations low and beatable.

TSR is also deeply problematic for "hot" companies that are over-valued by the market. Some companies expend great energy trying to control overly-exuberant market expectations. While a well-run, over-valued company may attempt to talk down market expectations, managing expectations down has proven to be incredibly difficult. In such situations, market pressures can overwhelm corporate management's ability to stay the course on their long-term strategy. Over-heated stock valuations are not only highly problematic for individual companies over the long-term, but also for the economy as a whole. The long-term interests of the company, which corporate directors are legally obligated to protect, are best served by reasonable stock market expectations not irrational ones.

Considering the difficulty of managing expectations down and the weak relationship between TSR and fundamental economic performance, we see considerable danger in the SEC endorsing TSR as the primary metric of corporate or executive performance.

Further, since the average investor is generally investing over long time horizons, TSR is a crude metric against which to assess CEO performance and the 5-year time horizon is too short for many industries. Rather than TSR, fundamental drivers of long-term company performance that are *within the executive's control* should be the primary focus of pay disclosure. Key fundamental drivers of long-term performance should be connected to the company's long-term strategy, difficult to manipulate and easy to measure.[xi]

Over-Emphasis on Comparability of Pay

We agree with a recent report by a Blue Ribbon Commission of the National Association of Corporate Directors (NACD) that states "peer group and market data should be used as a reasonability test for executive pay plan design; it should not drive decisions....The true drivers of an effective

compensation plan (including peer group selection) should be the unique strategic drivers of the company."[xii] We believe this advice is based on sound evidence.

Bloomberg Business recently investigated the perverse results of peer comparisons on executive compensation and found that rather than curbing excessive compensation, peer comparisons are used to simply justify higher compensation.[xiii] These findings are consistent with insights from Simon C.Y. Wong, an advisor to McKinsey and frequent lecturer at Northwestern Law, who noted that peer comparisons have created a culture of using pay to "keeping score" against each other.[xiv] Empirical research has backed up these assertions.

Pay comparability may be helpful for pay consultants and proxy advisory firms whose business models are built around standardized models of pay and corporate governance, but the unintended consequences for investors, companies and society as a whole outweigh the advantages provided to these select intermediaries.

Tabular Format: Implies a direct correlation between TSR and compensation, and is oversimplified

While we recognize that the tabular format described in the proposed rule is intended to enhance comparability, it is problematic for several reasons beyond the discussion above.

The first is that presenting this information in such a way implies that TSR (a problematic metric to begin with) is the primary objective for corporate leaders and that there should be a correlation between an executive's compensation and the company's TSR. We believe investors, companies and the economy as a whole are best served when corporate leaders focus on the fundamental drivers of long-term value rather than the expectations of financial markets.

The second is that the tabular format creates an illusion that executive performance and compensation are simple. The methodology companies use to determine executive compensation is often complex. TSR may be one of a number of metrics that boards use to assess performance but as described above, TSR can be misleading as a metric of fundamental value creation and is at best, inadequate on its own.

Our third concern is that a tabular format focused on TSR may crowd-out more important information about long-term strategy, investments in R&D and long-term capacity-building for a company performance and *reduce* transparency about critical issues that are important to investors.

Finally, a tabular disclosure requirement as contemplated will imply that executive compensation measured against TSR over the five-year period is endorsed by the SEC as a best or desired practice. It suggests that TSR is the primary indicator of an executive's performance.[xv] For companies that do not currently base their compensation packages on TSR, this disclosure may be misaligned with the board's best judgment about the long-term health of the company. It may amplify short-termism and impede long-term thinking. As discussed above, TSR is an inherently risky metric when linked to executive pay, and using disclosure rules to push companies to tie their executive compensation to this single metric creates a significant risk of companies making decisions to boost their TSR at the expense of the health of the company.

Executive compensation is determined by companies in a variety of ways and is often unique to a company's business models, culture, industry, and business cycle. Compensation structures vary even within the same industry. We understand that companies would not be limited to the tabular presentation of their NEO compensation, but we are concerned that the presence of a table will become a default reference point, particularly for less sophisticated investors. While we recognize the desire for comparability across companies and industries, in this instance, a simplified table as described in the proposed rule prioritizes comparability over accuracy and detail about the drivers of long-term value for an individual company.

Conclusion

SEC disclosure requirements shape the conversation between companies and their investors. The nature and content of SEC disclosure requirements also influence the ways corporate boards think about important business decisions for the long-term health of their company and the economy as a whole. SEC rules can either facilitate a richer dialogue or inadvertently narrow the dialogue by "crowding out" other important factors that are not included in the letter of the statute.

A large body of empirical and laboratory research on performance incentives demonstrates how difficult it is to craft financial incentives that affect behaviors involving complex mental tasks -- the kinds of tasks that characterize corporate executive responsibilities. Research demonstrates that it is exceedingly difficult to craft financial incentives that reliably lead to desired performance outcomes when complex or creative mental tasks are required. In fact, a large body of evidence suggests that financial incentives for complex tasks are more likely to undermine performance, ethical behavior and sound decision-making in unexpected ways. Given the compelling research in this area, great caution should be exercised in prescribing specific standards for incentive design.

To conclude, we find the proposed compensation disclosure rule to be too narrow, overly-prescriptive and focused on the wrong performance indicator, TSR. We believe a principles-based rule to implement Section 953(A) of Dodd-Frank would provide more meaningful disclosure as it would allow companies the flexibility to explain the actual rationale and decisions underlying their pay structures. A principles-based disclosure regime should focus on drivers of long-term value for the company, be tied closely to the company's mission and strategy, focus on benchmarks that are within the control of the NEO, and be linked to metrics that are difficult to manipulate. This may sacrifice comparability, but we believe this could facilitate greater transparency around information critical to average investors. The proposed rules state that the new disclosure "may be of most interest to less sophisticated shareholders," but we believe that disclosure resulting from the proposed rule as written will actually be misleading for all but the most sophisticated investors.

Respectfully,

The Aspen Institute *Business & Society Program*
Judy Samuelson, Miguel Padro and Anna Cronin-Scott

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