Pay Governance
Advisory Services to Compensation Committees

September 14, 2010

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: Comments on Executive Compensation Provisions in Title IX of the Dodd-Frank Act

We are submitting comments to the Securities and Exchange Commission to present our ideas on the implementation of certain concepts set forth in Title IX of the Dodd-Frank Act.

Pay Governance LLC is an independent executive compensation consulting firm formed in 2010, with approximately 40 consultants. We formed the firm in response to consultant independence concerns that exist in the market. Our partners each have decades of experience in executive compensation consulting. We advise the Compensation Committees of over 100 large US publicly traded companies, which gives us in-depth experience with the analysis of executive pay.

Our letter provides suggestions for two areas of the Dodd-Frank Act: The pay versus performance disclosures (Section 953) and Compensation Committee/Compensation Consultant independence (Section 952). We also offer some general comments regarding the median pay ratio (Section 953), and recovery of erroneously awarded compensation (Section 954).

Pay-For-Performance Disclosures (Section 953)

We believe additional disclosure of executive compensation "actually paid" versus financial performance will be a valuable addition to the CD&A, and will help investors better understand the executive pay decisions of the company, and make more informed "Say-on-Pay" votes.

A properly done pay-for-performance study enables a Compensation Committee to determine if it was successful in aligning executive pay levels, opportunities, mix, and performance measures/goals with the value created for shareholders. The Committee will know it has been successful if there is alignment between "actual pay" and historical performance on an after-the-fact review.

However, a pay-for-performance disclosure will not be useful *unless* the time periods for analyzing executive pay and company performance match. The time periods do not match in the Summary Compensation Table (SCT) because the SCT shows actual cash earned in the previous year, plus the grant value of equity representing an estimate of value making assumptions about future performance (typically, future stock price performance). Even if the size of those new equity grants reflects prior year performance to some degree, the future value of those awards cannot be determined at grant.

We have two recommendations for useful pay-for-performance comparisons. The first pertains to annual pay-for-performance. The second relates to longer-term pay-for-performance. Our recommended approaches are not the only way to look at pay-for-performance, but we think they are viable approaches that allow for comparisons to the company's own historical performance and to peer group performance.

1. One Year Performance Snapshot

For one-year performance, the comparisons should be to short-term compensation (i.e., the sum of salary and any incentive plan or discretionary bonus that is based on performance over the one-year period). Equity grants made in the year should not count as short-term compensation unless they vest in the year of grant. As we discuss in the next section, the vast majority of equity grants made in a given year do not represent compensation "actually paid" in that year. The performance analysis we'd recommend includes the following steps.

1. Compute actual short-term compensation paid versus the amount paid in the previous year, for both the company and its peer group;
2. Select three metrics of one-year financial performance, using the metrics in the annual incentive plan(s) as a guide;
3. Present the following analyses:
   a) Change in compensation compared to change in financial performance on a year-over-year basis;
   b) Change in compensation compared to the change in compensation for the peer group;
   c) Dollars of actual short-term compensation as a percentile in comparison to the peers, compared to financial performance on the three metrics as a percentile of the peers.

2. Longer-Term Total Compensation

When evaluating long-term compensation against performance, it is critical to include both cash pay and equity grants. However, it is difficult to definitively say when equity grants are "actually paid" due to the terms and conditions of the grants. Since a large portion of most executive compensation packages is delivered in equity, a consistent approach is needed for determining when the equity grants are actually paid.

To illustrate the complexity, let's use the example of a stock option is granted on January 1, 2010 at fair market value with a three-year vesting period and a ten year term. Multiple interpretations are possible as to when the option grant is "actually paid":

a) The hypothetical value on the date of grant is not actual payment, since the award is not vested and has no immediate intrinsic value;

b) The date of vesting could be used as a proxy for "actual" payment, although vesting does not automatically correspond to exercise;

c) The date of actual exercise could be used since this would match up with the "realized" gain on the option, but since the timing of exercise could take place at any time between vesting and term, it would be complicated to match the time period from grant to exercise with a performance period, especially given that an option holder could exercise different portions in different years;

d) These problems are less pronounced for restricted stock and performance shares, since it would be easier to assume that the vesting dates often correspond to "actual" payment. However, this is not always the case (i.e., companies might grant RSUs which are deferred beyond the vesting date, and/or use performance shares which are subject to additional vesting beyond the earn-out period).

Three-Year Realizable Pay to Capture Long-Term Pay-for-Performance[1]

We recognize that there is no perfect methodology for comparing pay-for-performance over a period, given all the complexities of equity grants. However, our staff has conducted economic research using a sample of thousands of companies over the past ten years to determine the optimal way to look at long-term pay-for-performance.

Our methodology, which we call "Realizable Pay", matches calculated payouts to the same time period, and allows for comparisons to peers groups or indices. It looks at the value achieved on equity grants at a point in time <u>after</u> grant, which allows us to incorporate the gains achieved on stock options (if any), and the earn-out of performance shares. We have used this approach for many public companies, and have found it to be a useful tool for Committees and companies to assess their alignment between pay and performance. Even if the size of the new equity grants partially reflected the prior year performance of the company, the Committees and shareholders will still benefit significantly from an after-the-fact comparison of historical performance of the company to the value those awards actually produced.

[1] This type of analysis could also be done using a different time period, such as five years

We explain the methodology below, using a time period of 2008-2010 as an example.

Pay Elements Captured By Three-Year Realizable Pay (2008-2010)[2]

• 2008-2010 actual salaries, adding back any deferred compensation
• 2008-2010 actual bonuses paid, from either non-equity awards or discretionary bonuses
• Equity grants made during the 2008-2010 period, assuming all awards are still held, valued using the 12/31/10 stock price:
  ▪ Gain (in the money amount) on stock options
  ▪ Value of restricted stock
  ▪ Value of performance shares earned for the cycle covering 2008-2010

We look at performance for the same 2008-2010 period, using TSR (Total Shareholder Return) and typically two other metrics, using the metrics in any performance share/cash plans as a guide. For comparison to peer groups, financial metrics are translated to growth rates or ratios (i.e., EPS growth, ROE) to allow for comparison across the sample.

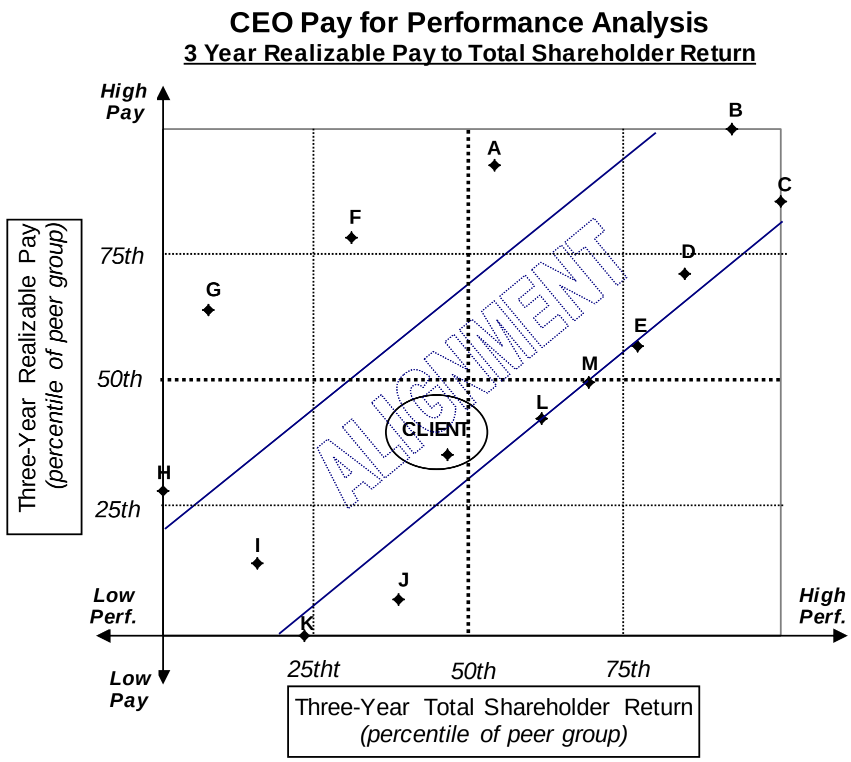
We then "map" the executive's Realizable Pay relative to its peer groups and establish a percentile for realizable pay. Likewise, we compute a performance percentile for the same time period using the TSR and the financial metrics. (See graph on next page).

By comparing a company's Realizable Pay percentile to its performance percentile for the same time period, it is possible to see how well a company's pay and performance was aligned. For example, if realizable pay and performance are both near the median (like the Client positioning in the graph), this appears to be good alignment. On the other hand, if realizable pay is well above-median with below-median performance (like Company F in the graph below) this indicates poor alignment in the pay program, warranting a careful review.

In our consulting work, this methodology has helped individual clients make changes to their future compensation programs, such as changing the vehicle mix, size of future grants, and/or the difficulty of goals.

[2] For ease of explanation, we have excluded other items of compensation reported in the SCT

EXAMPLE



Compensation Consultant Independence (Section 952)

The Dodd-Frank Act provides that there should be factors used to evaluate the independence of a compensation consultant. The Act is clear that that these factors should be competitively neutral, and preserves the ability of Compensation Committees to choose between categories of consulting firms. From our perspective, the majority of executive compensation consultants currently in the market can be viewed in four categories: longstanding boutique firms, longstanding multi-service human resources consulting firms, single practitioner firms, and recently formed boutique firms. The latter are comprised of former multi-service firm consultants who have recently formed boutiques to address concerns about consultant independence in the market. Pay Governance is in this category.

Objectivity and independence of advice is a basic tenet of our ability to be effective professionals.

We believe it is important that Committees have a robust selection of consulting firms from which to choose, thereby ensuring a competitive market in which no one firm has a dominant share of the market (which would create its own unique set of independence issues).

The Act outlined five factors to guide a Compensation Committee's selection of a consultant, with further details to be developed by the SEC. We support the use of these five factors as valid ones for consideration in the evaluation process. In the implementation, these factors should provide guidance to the Committees, but not create an outright prohibition or bias against any category of consulting firm. Based on our experience, we offer some suggestions to ensure that the factors support the intent of Section 952:

1. Provision of other services to the company.

   - The SEC established fee thresholds and rules last year for compensation consultant disclosure purposes. It seems reasonable that these same thresholds and rules could be maintained as guidelines for evaluating the amount of other work being done, although many Committees may, in fact, use $1 as their own guideline on independence.
   - Another alternative would be to establish guidelines for other compensation consulting work as a percentage of executive compensation advisory work (i.e., that the other work would not be more than 50% of the executive compensation work). These may be more effective than the dollar thresholds that the SEC set last year because they would relate the size of the other services to the size of the executive compensation advisory work.

2. Amount of fees as a percentage of total revenue

   - A guideline that fees are no more than 20% of total firm revenues would ensure that one client does not dominate a firm’s business. This guideline is probably fair and reasonable for most of the larger or established consulting firms. However, for a recently launched single practitioner firm, this type of guideline could create competitive harm. Providing for a three-year phase-in of the guideline might be helpful in this regard.

3. Policies and Procedures of the firm designed to prevent conflicts of interests

   - Consulting firms should have a process for evaluating new client opportunities to ensure that there are no relationships between the prospective consultants and the Compensation Committee members that would damage independence and objectivity. There should be policies in place regarding gifts, and client entertainment expenses.

4. Business or Personal Relationships Between Consultants and Committee Members

   - It will be important to define what constitutes a business relationship. We assume this is intended to capture separate business dealings with a Committee member, which might include private financial investments made with a Committee member.

   - Since many Compensation Committee members also serve on other public company boards, it is possible that a consultant could work with the same Committee member on more than one client. It is also possible for the CEO of one client to serve on the Compensation Committee of another client. It would be helpful for a Committee to understand if there are other consulting relationships that include the Committee members, but we think these types of relationships are only relevant to the extent they damage independence and objectivity.

5. Any stock owned by the consultants

- Stock ownership evaluation should exclude mutual and index funds
- Some time period should be provided to allow a consultant to sell shares of stock if they have historically owned shares in a new client (i.e., 180 days)

In reviewing the comments that the SEC has already received, there were comments proposing additional criteria for the consultant independence factors beyond those outlined in the Dodd-Frank Act. We are concerned that certain additions would benefit one category of consulting firm (i.e., longstanding boutiques) over other categories of consulting firms. Of specific concern is a suggestion to review the job histories of the individual consultants on a client engagement team to determine if those individuals had worked for a previous employer in the past three years, and if that previous employer had provided other consulting services to the client.

Additional criteria, beyond those factors outlined in the Dodd-Frank Act, will not enhance consultant independence. The existing list is complete and sufficient. There is no empirical evidence that consultants from one type of boutique would provide biased, non-objective advice relative to another type of boutique. We have two concerns with backward-looking criteria, such as a review of a consultant's job history over the past three years. The first concern is that it will create competitive harm for firms such as ours, who have recently hired consultants from full-service firms who wanted to join a freestanding boutique. The second concern is that this type of overly prescriptive criteria will ultimately lead to fewer choices for Compensation Committees and a less robust, less competitive market for executive compensation advisory services.

CEO Pay Ratio (Section 953 b) and Recovery of Erroneously Awarded Compensation

As other commenters have noted, it will be important to develop a practical approach to both of these sections.

For the CEO Pay Ratio, payroll information is often not readily available to calculate median employee compensation, especially for companies with non-US employee payrolls.

For recovery of compensation erroneously awarded due to restatement, it is not clear cut how to "claw back" compensation tied to measures not involved in a restatement. Implementing a claw back on these other aspects of the compensation plan could be quite complex, and likely will require some Committee/Board discretion. Decisions on how to claw back stock options granted during the restatement period will be particularly different, especially since the stock price has likely factored in the restatement by the time a claw back decision is being made.

Useful suggestions in this regard have been put forth by several other commenters, including the Center On Executive Compensation and Frederic W. Cook & Co.

In Closing

We thank the Commission for providing the opportunity to make comments before the proposed rules are published. We would be pleased to provide more information about our suggestions, and will be following further developments with great interest.

Sincerely,

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