Dear Secretary Countryman:

I am an Engaged Shareowner at ActiveAllocator Activist Capital Advisors. I am responding to the Commission’s request for comments in Release No. 34-94074, entitled “Reopening of Comment Period for Pay Versus Performance,” to implement Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”). In this letter I draw attention to the unique and special issues that arise within executive compensation actually paid and the financial performance of the company in the context of Private Equity Leveraged Buyouts.

Unique Compensation Considerations in Private Equity Leveraged Buyouts

There are unique considerations in private equity leveraged buyouts (LBO) where sponsors seek to create strong incentives for a small group of key managers. There are three main components of management compensation in most buyouts which have ramifications on Say on Pay disclosure: (i) Rollover of existing equity; (ii) New equity / options to Management; and (iii) Employment contracts. These equity arrangements are focused on a small group of key management members usually around 8-12; sometimes as few as 3 or as many as ~25 in mega deals. The structure provides for significant upside upon achieving certain return and/or performance goals and invariably allows for no liquidity/exit prior to investor exit - ceding such option is in essence a de jure cost imposed on recipients, but the cost is not explicit. It is important to consider the specifics of these in designing rule making for these do not lend themselves to the ordinary course of business and create unique monetary benefits and costs going beyond traditional components of pay to recipients.

(i) Rollover of Existing Equity: Sponsors typically require key management to contribute equity and/or cash to the deal to ensure that their incentives are aligned with investors. Management
is often required to roll 20%-50% of pre-deal equity ownership into the new company where current ownership positions can be rolled tax-free in general. These components include common stock owned outright, unrestricted common stock and vested restricted stock, and may include options. Unvested restricted stock and other unvested deferred compensation can only be contributed on after-tax basis. Existing equity positions are valued at the deal price. Options are valued at spread between deal price and strike price. Sponsors generally require each manager to contribute a specific amount and Management typically has flexibility around how they contribute (equity, cash, etc.). Sponsors may offer to lend management money to invest in equity, but this is not very common and when debt is truly non-recourse, it is treated as options for tax purposes (ordinary income taxation on gain). This is mostly used where Management doesn’t have enough funds/equity to participate otherwise. Equity typically contains provisions to ensure that management cannot exit prior to investors and in general it comes with no forfeiture risk but has exceptions for termination “for cause”. These mandatory provisions be treated as foregoing or detracting from received compensation, for in ceding options to exit, Management does incur an intangible cost which is a transfer in rent from Management to the Company.

(ii) Management Equity Incentives: New equity is the primary method of securing significant upside to management as reward for achieving certain performance targets. In a typical LBO, management is awarded new equity equivalent to sometimes ~10% ownership of the company, on a fully-diluted basis (1% – 5% for “mega” LBO transactions). New equity grants can often be increased in return for increased management equity rollover. The typical CEO rollover is 25% - 50% of his / her after-tax gain on sale and the CEO gets the biggest share of new equity. The remainder is concentrated in the top management team (15 – 25) people. Also new equity grants primarily come in the form of options though certain sponsors may seek to adopt other, more tax-efficient strategies. Economics and payoff profiles are generally consistent with options. There are commonalities in vesting conditions such as 30% – 40% of total vests over time (usually 3 – 5 years) or 60% – 70% of total has vesting tied to achieving certain goals. IRR-based targets most common, but can also be based on other metrics, like EBITDA, IRR, cash-on-cash return, etc. Options can also be awarded at a premium strike price to achieve similar results. There is usually an 8-year cliff vest, but percentages accelerate as targets are hit (for example, if 1-year target is hit, 20% accelerates, if 5-year targets are hit, then 100% would be accelerated / vested). Performance options may be tiered with half of the performance options set at one IRR level (i.e., 20%) and a second tier set at a higher IRR level (i.e., 30%). Management generally forfeits any new equity in the case of termination (regardless of reason) and provisions are put in place to ensure that management cannot exit prior to investors. These terms differ between firms rendering peer group benchmarks as currently envisaged in the proposed rule impractical to rationalize and report.
(iii) Employment Contracts: Sponsors typically seek to make certain changes to employment contracts, while keeping base salary and bonus levels generally unchanged. Sponsors typically seek to remove certain elements of management’s parachutes such as “Quit for good reason” clauses or "Tax gross-up rights" for future change-of-control payments. Sponsors generally also seek to strengthen certain restrictive covenants particularly non-compete clauses.

Exit Provisions for Management: Typically, all restricted stock and options held by management vest in a change of control in the investment. Exit mechanisms for management vary depending on sponsors’ exit scenarios. In a sale or other private market change of control, management may have tag along and/or drag along rights: (i) Drag along – Sponsors can require management to sell their shares pursuant to the same condition under which sponsors sell and (ii) Tag along – Management has the right to sell a portion of their shares in proportion to percentage sold by sponsors. In an IPO, management can sell shares in any secondary offering pro rata with sales by the sponsors and Management would be subject to lock-up agreement as requested by underwriters following public offerings.

Employee Change in Control Compensation Programs: Companies often implement several employee compensations programs as they prepare for a sale process in order to facilitate a successful transaction. These programs are mostly put in place well before the commencement of the sale process and are key to aligning Company’s interest with those of a potential LBO group. Employee compensation programs that Companies consider include; (i) Severance Package—Payment to employees who are terminated after closing; (ii) Retention Bonus—Payment to employees as reward for staying through a predetermined transition period; (iii) Transaction Bonus—Bonus to encourage executives to maximize the sales proceeds from a transaction; (iv) Companies must make several decisions prior to the selection of a program taking into account objectives to be achieved through the program such as employees in the organization that will be included in the program. And the Dollar amount set aside for the total compensation plan, the amount each employee should receive relative to the current salary and bonus and avoid the prospect of management leaving upon the announcement of a sale. These are intended to gain the support of current management for the sale of the business and provide management with incentive to run the business as it transitions to new ownership. They also entice management to sign non-compete and non-solicitation agreements and tie management’s interests to those of the selling company and its shareholders. This essentially compensates management for their work and potential financial uncertainty caused by the sale process.

As is now perhaps apparent from the above many of these are not straightforward pecuniary benefits that can be summed up in a reported number. Many of these components involve Real Options with value that the current accounting rules and provisions including under GAAP do not
price. These are not included in formal calculations of compensation and treated as contracting intangibles, which whilst retaining and transferring economic value to and from recipients, are not priced.

I hope that these considerations may help you in your arriving at changes to Pay Versus Performance Rule.

Yours Sincerely

Sameer Jain

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