March 4, 2022

Via Internet Comment Form

Ms. Vanessa Countryman
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File Number S7-07-15

Dear Ms. Countryman:

I am writing this letter to provide additional comments on the Commission's proposed amendments to Item 402 of Regulation S-K to implement Section 953(a) of the Dodd-Frank Wall Street and Consumer Protection Act. I have already submitted comment on July 6, 2015, all of which continue to be relevant (Link to TCA Prior Comments). This letter is provided to reinforce those same comments and to address some of the new, additional elements recently proposed by the Commission to be included as part of the pay for performance disclosure.

Technical Compensation Advisors is a boutique compensation consulting firm that focuses on complex compensation matters including regulatory issues, disclosure, accounting, valuation, tax as well as anything quantitative, financial or statistical. A number of the clients I assist would be included among the companies that would be expected to comply with the proposed rule. I am providing the following comments based in part on my discussions with these issuers.

The comments I provide below generally oppose the adoption of a prescribed, "one-size-fits-all" approach to providing pay for performance information and specifically address certain questions posed throughout the proposing release. While the Commission has enhanced the original proposed rule to include even more disclosure that is supposed to address the "one-size-fits-all" concerns expressed by many commenters, the enhancement only provides only dubious benefits to investors. I believe the Commission's attempt to address these concerns falls short and there doesn't appear to be any consideration of the other concerns expressed by many prior commenters. Accordingly, my comments are highly repetitive with my prior letter, summarized as follows:

- The Commission should focus on reducing the costs of compliance, reducing complexity and limiting the expansion of already unwieldly executive compensation disclosures by adopting a principles-based approach to illustrate the pay for performance relationship
    - Addressing this issue by requiring disclosure of more repetitive information does not alleviate these concerns
- If the Commission insists on prescribing an approach, then consider:
    - Making the pay period and performance period consistent with each other by defining:
        - "Executive compensation actually paid" as the incremental compensation earned in a given year, as described in Section IV.C.3 of the original proposing release dated April 29, 2015

        - Financial performance as a one-year measure for each of the years required to be disclosed in the table (i.e., not cumulative)
    - Eliminating the two prescribed income measures but continue to allow for a "Company-Selected Measure"
    - Revising or eliminating the proposed requirement to list the "Five Most Important Company Performance Measures. . ."
        - Creates a de facto requirement to have performance measures (are companies permitted to only pay salary?)
        - Can be redundant with narrative provided in the Compensation Discussion and Analysis (CD&A)
    - Allowing for equity award values to reflect intrinsic values or safe harbor fair values
    - Limiting disclosure to only the principal executive officer (PEO) and only compensation provided while in the capacity of PEO should be considered
    - Eliminating the requirement to aggregate compensation for multiple PEOs
    - Removing total compensation as reported in the Summary Compensation Table since it does not relate to "executive compensation actually paid" whatsoever
    - Eliminating the duplicative requirement to disclose peer company performance
    - Eliminating the requirement to provide a duplicative description of the relationship between pay and performance if it is already evident from a table or graph
    - Exempting smaller reporting companies from pay for performance disclosure
- Regardless of whether the Commission chooses to adopt any of the above suggestions, I urge the Commission to address the following:
    - Any timing mismatch between the period over which financial performance is measured and the period over which executive compensation actually paid is measured
    - Lacking clarity on defining "cumulative" financial performance in a given year
    - Guidance on whether and how to apply illiquidity discounts on the fair value of equity awards for purposes of this disclosure as well as disclosure in the Summary Compensation Table
    - Monitor recent trend of incentives based on impact of "stakeholders" other than shareholders and consider permitting disclosure of the costs borne by shareholders for paying executives based on performance metrics that might not be aligned with shareholder returns

The remainder of this letter provides more detail on the above comments.

<u>Focus on reducing costs and complexity</u>

Section 14(i) of the Securities Exchange Act of 1934 requires the disclosure of "information that shows the relationship between executive compensation actually paid and the financial performance of the issuer, taking into account any change in the value of the shares of stock and dividends of the issuer and any distributions." The specific requirements from this language are somewhat elusive. However, it is clear that Section 14(i) does not require:

1. Specific executives to be considered
2. Aggregating executive compensation actually paid
3. Specific time period(s) to be examined

4. The use of a peer group
5. Restating total compensation from the Summary Compensation Table

According to the Commission's website, "the mission of the U.S. Securities and Exchange Commission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." The website continues to state that ". . . the SEC requires public companies to disclose meaningful financial and other information to the public." Arguably, the proposed rule seeks to provide meaningful financial information, as promised. However, the Commission acknowledges that the proposed disclosure would only provide information that is either already available elsewhere or can be easily calculated by investors. The hope is that the proposed disclosure would be useful to investors and save them time, making the additional costs associated with providing the disclosure worth it.

However, there is significant concern that the additional disclosure would increase complexity and cause confusion since many companies will be compelled to explain any differences between the prescribed approach and the approach a particular company uses to evaluate pay for performance. The costs of this increased disclosure might be more than those estimated by the Commission and might more than outweigh any benefits from the prescribed approach. Accordingly, the Commission should adopt final rules that reduce the costs of compliance and the costs borne by investors by not forcing companies to provide superfluous information that is not required by law. The most practical approach would be to provide principles-based disclosure of the pay for performance relationship which would allow companies to leverage the analyses already conducted for purposes of determining executive compensation. However, if the Commission seeks to prescribe an approach, some specific actions the Commission should consider include:

1. Limiting the number of executives covered by the disclosure (e.g., only the PEO)
2. Abandoning any requirement to disclose peer group financial performance (especially if "executive compensation actually paid" is not provided for peers), and
3. Eliminating any requirement to restate total compensation from the summary compensation table since comparisons to "executive compensation actually paid" are meaningless and would only cause confusion.

<u>Make final rule principles-based</u>

Many large companies already provide pay for performance analyses in the Compensation Discussion and Analysis (CD&A), some of which are far more sophisticated than anything the Commission could or should require. As the Commission acknowledged in its proposing release, the pay for performance analyses currently provided by companies and their advisors vary widely. There is a reason why there is no consensus– each company has unique circumstances that requires a different approach. Different business models exist, some more capital intensive, some companies have investments with longer time horizons, narrower margins, etc. Each company decides an appropriate pay package based on these unique circumstances and chooses to reward executives based on different financial measures. True pay for performance should measure what the executives are actually being paid for and that may not always be based on total shareholder return and may not have anything to do with the performance of other companies.

The Commission's attempt at adding performance measures other than Total Shareholder Return (TSR) is commendable since it would allow investors to compare pay to actual results whereas TSR allows

investors to examine the relationship between pay and expectations as reflected in a publicly-traded security. Only focusing on TSR as the original proposing release did implies that fluctuations in the share price are entirely attributed to the performance of named executives. Share-based compensation focuses on changes in future expectations and not necessarily actual performance better measured by a metric in the company's financial statements (pro-forma or GAAP) or other performance metrics. For other pay elements, it would be more appropriate to measure these actual results rather than future expectations.

By prescribing a one-size-fits-all approach, companies would be compelled to add numerous pages to their already hefty and unwieldly proxy statements in an attempt to explain the differences between a prescribed, mandated disclosure and the analysis they believe is more accurate. These additional pages would add substantial costs not just from the time and effort spent on reconciling different pay for performance analyses, but also in defending their customized analyses from attacks by gadflies with certain political agendas. These gadflies will attack any non-prescribed analyses as diabolical attempts to distract and obfuscate from the required disclosure. Quite often, they are not investors and the Commission has no obligation to accommodate them. Yet any attempt by the Commission to placate non-investors would ironically harm the very investors the Commission is charged with protecting by imposing additional costs which would ultimately be borne by shareholders.

I am urging the Commission to adopt a principles-based rule that will permit companies to provide analyses that is consistent with the approach used in making pay decisions. This would allow companies to demonstrate the relationship between the pay actually earned and the actual performance measures used.

Changes to proposed, prescriptive disclosure

If the Commission insists on prescribing one approach for all companies, then the Commission should consider a number of revisions to the proposed rules that would make the disclosure more meaningful and less confusing. The Commission should consider the following:

Align timing of "executive compensation actually paid" with financial performance

Any serious attempts to demonstrate whether pay and performance are correlated must start with a consistent time period over which both elements are examined. The proposed rule fails to do this since the definition of "executive compensation actually paid" contains pay elements from different time periods. For example, comparing the vesting-date fair value of an equity award that vested over five years to a one-year performance measure is incongruous and misleading. The proposed rule makes the implicit assumption that the time period over which the performance measures are evaluated matches the vesting period of the awards being examined. That is simply not the case and the Commission acknowledges this failure in the proposing release.

Ideally, the pay for performance relationship for each element would be evaluated independently from other elements based on its vesting period. So, for example, an equity award that vested over three years would be compared to performance (earnings, TSR, etc.) over the same time period. Changes in value from the target value or grant-date fair value to the vesting date can be compared to the changes in shareholder value (e.g., change in market capitalization plus dividends or TSR). If changes in market

capitalization are used, then the executive compensation actually paid can be expressed as a percent of the shareholders' change in wealth. However, to evaluate each pay element independently over time would be extremely cumbersome, and costly.

In Section IV.C.3 of the proposing release, the Commission identifies "incremental compensation earned" as an alternative approach to determine "executive compensation actually paid." This could then be compared to an annual measure of "financial performance" (e.g., one-year TSR or one-year EBITDA). I believe this approach would be better than the proposed approach since the timing of pay and performance would be more aligned. Consistent with the description provided in the proposing release, incremental compensation earned for a given year could include:

- All annual pay earned from salary, bonus, annual incentives (equity and non-equity), all other compensation and changes in pension values
- Change in "paper gains" on all long-term compensation (equity and non-equity)
    - For awards that vest during a fiscal year, the difference between the value at vesting and the value at the end of the prior fiscal year
    - For awards that remain unvested at fiscal year-end, the year-over-year change in value
    - For awards granted during the fiscal year, the value at fiscal year-end (captures the target or grant-date fair value as well as subsequent changes in value)

Incremental compensation earned is consistent with other tabular disclosure and many of the data are already reported in the Outstanding Equity Awards at Fiscal Year-End Table and the Option Exercises and Stock Vested Table. While restating these data might be redundant and unnecessary, it would be an improvement over the proposed approach because of the time savings involved and consistency with other already-provided disclosure. This consistency would limit the confusion associated with adding a new element that is unrelated to those already disclosed.

Eliminate Required Income Measures but Continue to Allow for a "Company-Selected Measure" and Eliminate Required Table Listing the Five Most Important Company Measures

As I mentioned above, the Commission's attempt to address concerns about solely focusing on TSR are commendable, however, prescribing income measures would be redundant with other disclosure and would not necessarily be consistent with the compensation measures actually used to determine pay. Allowing companies to provide a measure that they select is a much better approach and the Commission should continue to provide for that in its final rule.

The table listing the five most important measures provides a de facto requirement to provide performance-based pay. While the vast majority of companies are compelled to provide performance-based pay, there should not be an implicit requirement to do so. It is plausible that a company may not provide performance-based pay. For example, Berkshire Hathaway appears to have a history of only providing salary, discretionary bonuses and some perquisites to the named executives. There wouldn't appear to be any particular performance measure to disclose in a table.

Allow for vesting-date values of equity awards to reflect intrinsic values or safe harbor fair values

Section IV.C.3 of the proposing release points out numerous benefits to adopting "incremental compensation earned" over the proposed approach, particularly related the timing mismatch issues with the proposed approach. However, the Commission appears to be very concerned about the potential for increasing the reporting burden because of the need to revalue equity awards every year until vesting. For many companies, this burden may not be as severe as the Commission believes (e.g., for companies that do not grant stock options) and can be mitigated if the Commission permits the values be determined using an intrinsic value method or, alternatively, a safe harbor valuation approach.

For stock options, the intrinsic is easily determined as the positive difference between the stock price at the time the value is determined and the exercise price of the option or zero if the stock price is less than the exercise price. It is the value the executive would receive if the options were exercised immediately. This is the simplest approach to valuing stock options and would be consistent with Item 402(j) requirements to quantify post-termination or change-in-control values. In addition, as mentioned above, many of the intrinsic values are already available in the Outstanding Equity Awards at Fiscal Year-End Table and the Option Exercises and Stock Vested Table. Arguably, however, the value of an option upon vesting should also reflect the "time-value" associated with the remaining term to exercise. Requiring companies to determine vesting-date fair values calculated in accordance with ASC 718 would ensure some consistency across companies, but, unlike the disclosure of grant-date fair values, would impose an addition cost burden. This burden could be more substantial for companies that use a lattice model to value stock options or a Monte Carlo model to value equity awards with market conditions.

An alternative that the Commission could consider is to allow for a safe harbor valuation approach similar (or identical) to the valuation methodologies provided by the Internal Revenue Service. Two Revenue Procedures in particular might be helpful: Revenue Procedure 98-34 and Revenue Procedure 2003-68. Revenue Procedure 98-34 provides an approach to determine the "Computed Expected Life" of an option by multiplying the remaining contractual term of an option by the ratio of grant-date expected life to original contractual term. Volatility and dividend yield would be based on the recent financial statement disclosure. These inputs could be used in a "generally recognized option pricing model" (e.g., Black-Scholes-Merton) or used in conjunction with the safe harbor valuation tables provided in Revenue Procedure 2003-68. Three safe harbor tables were developed (representing low, medium and high volatility) to value stock options for purposes of IRC §§ 280G and 4999. Option values would be determined based on the moneyness of the option (i.e., the ratio of stock price to exercise price) and the remaining expected life (which can be determined using the approach discussed above).

By using either the intrinsic value or a safe harbor value as outlined above, the costs associated with valuing stock options as of a vesting date can be substantially reduced. However, there does not appear to be a comparable safe harbor approach for equity awards that have market conditions which often require complex Monte Carlo valuations. The Commission should consider providing such a safe harbor approach for these other awards (which would be very difficult to develop) or revert to paper gains as suggested above.

Limiting disclosure to the PEO and to pay provided only in the capacity of PEO; eliminate the requirement to aggregate the pay of multiple PEOs

Another step the Commission might consider to reduce the cost burden of disclosing pay versus performance is to limit the disclosure to only the PEO. The PEO is the only named executive officer (NEO) that can be compared across companies and focusing on this executive eliminates distortions caused by the inevitable differences in the job responsibilities of other NEOs at different companies and the turnover of other NEOs. In addition, the vast majority of the executive pay scrutiny is focused on the PEO. For example, Institutional Shareholder Services (ISS) only looks at the PEO in its pay for performance analysis. This suggests that the costs associated with providing data for additional executives might not be justifiable.

To help avoid distortions, only pay provided while in the capacity of PEO should be considered (i.e., compensation provided to an individual prior to being promoted to PEO should be excluded from the analysis) and pay for multiple PEOs should not be aggregated. If more than one PEO exists for a given year, data for each PEO should be provided separately so that each executive can be evaluated independently.

Eliminate the requirement to show total compensation from the Summary Compensation Table

While it might be desirable to compare grant-date fair values of equity awards (or target values of non-equity awards) with their values at vesting, the proposed rule does not accomplish this due to the mismatch in timing. The value that the Commission is proposing to include in the table is already available in the Summary Compensation Table and to provide it again in the proposed table is not only redundant, but misleading since investors would be drawn to compare total compensation for a given year to the value that vested in the year, but granted in a prior year. These two figures simply cannot be compared.

As mentioned above, it would be more appropriate to compare the grant-date fair value with the vesting-date fair value for each award independently. Requiring this analysis would be cumbersome and costly.

Eliminate duplicative requirement to disclose peer performance

The proposed rules would require that peer performance be provided without any corresponding peer pay. As the proposing release indicates, there are practical implementation considerations associated with providing peer compensation and doing so would impose higher costs. In light of these considerations and costs, the Commission chose to propose that only peer group performance be provided in the same table as the company's pay and performance. If the relationship between peer company compensation and peer company performance cannot be evaluated alongside the reporting company's compensation and performance, then the proposed disclosure is merely redundant with the performance graph required by Item 201(e) and does not provide any meaningful information related to the competitiveness of pay.

Eliminating the requirement to provide a duplicative, description of the pay for performance relationship

Proposed Item 402(v)(5) would require companies use the information provided in the proposed table to provide "a clear description of the relationship between the executive compensation actually paid . . . and the cumulative total shareholder return." This disclosure could be redundant if the information is evident from the table itself. Accordingly, the final rule should only require a description if the relationship is not evident from the tabular disclosure.

Exempting smaller reporting companies from pay for performance disclosure

As I mentioned above, many large companies already provide pay for performance analyses in the CD&A. Smaller reporting companies, however, have not been required to provide a CD&A and have not provided the same level of detail as larger companies do. While there is a significant concern that there would be substantial costs associated with providing a prescribed pay-for-performance analysis at large companies since they would be compelled to reconcile a prescribed pay for performance analysis with one that they believe is more accurate, the concern is much greater for smaller reporting companies. If smaller reporting companies become subject to the final rule, there would be a disproportionate increase in costs associated with compiling pages of discussion reminiscent of a small CD&A.

Issues that should be addressed, regardless

If the Commission chooses to adopt a final rule that does not reflect my suggestions, I would still urge the Commission to address the following issues:

Timing mismatch

While I believe that using "incremental compensation earned" would address the mismatch between the time period over which pay and performance should be measured (assuming that each year in the proposed table reflects a one-year TSR and one-year performance in a company-selected measure), there may be other valid approaches to consider. Regardless of the approach ultimately required, it is critical that performance and executive compensation actually paid be measured over the same time period. Otherwise, the comparison would be meaningless and the additional costs associated with the final rule would be wasteful to shareholders.

Defining cumulative financial performance

The original proposal, as written, lacks clarity with respect to the definition of "cumulative total shareholder return" in a given year. Many have interpreted the proposal to mean that the first year in a five-year table would reflect one-year TSR, the second year would reflect two-year TSR, etc. up to a five-year cumulative TSR. It would be surprising if this was the Commission's intent since doing so would only exacerbate the timing mismatch between compensation actually paid and financial performance. If this is the Commission's intent, then the corresponding compensation actually paid figures should be adjusted to reflect cumulative pay to be consistent. Note that if five separate one-year TSR figures are provided, one can easily calculate a cumulative TSR by simply multiplying the annual figures together.

I urge the Commission to provide clarity on the definition of cumulative financial performance.

Guidance on illiquidity discounts

As I mentioned in my prior letter, there has been a trend to apply illiquidity discounts on the value of equity awards that contain post-vesting holding requirements. Whether this discount is appropriate for public companies under ASC 718 is open to debate. Understanding that it might not reflect the Commissions views, a speech given by Barry Kanczuker, Associate Chief Accountant at the SEC in 2015 (Link to Kanczuker speech) referenced ASC 718-10-55-5, which states that "…if shares are traded in an active market, post-vesting restrictions may have little, if any, effect on the amount at which the shares being valued would be exchanged."

Regardless of the Commission's current views on this matter, there are implications for executive compensation disclosures since the disclosure rules rely heavily on ASC 718 valuation guidance. In particular, applying these discounts to values disclosed in accordance with Item 402 might result in counterintuitive (or perhaps, nonsensical) disclosure. I addressed this issue in an email alert in January 2016 (Link to Illiquidity Discount Alert).

To illustrate the issue, assume a company grants two stock awards to two NEOs. Each grant is for 10,000 shares with a grant-date stock price of $50. The grants are identical in all respects except that one vests after 5 years with no additional restrictions (e.g., mandatory deferral) after vesting while the other one vests after 3 years, but has an additional 2-year mandatory deferral after vesting. If an illiquidity discount can be appropriately applied, the 5-year vest award would show a $500,000 value in the Summary Compensation Table while the 3-year vest award would show something lower – perhaps $400,000 if a 20% discount can be applied. This result is counterintuitive – the award with longer vesting has a higher value than the award with shorter vesting.

With respect to the proposed pay for performance rules, the Commission needs to provide guidance on whether and how companies are permitted to apply these discounts when calculating the vesting-date fair value of equity awards. Irrespective of the proposed rule, the Commission should consider whether this type of discount should be applied to grant-date fair values and issue a Compliance and Disclosure Interpretation (C&DI) addressing this issue. Note that Instruction 3 to Item 402(c)(2)(v) and (vi) and C&DI 119.20 require that service-based forfeitures be excluded from the calculation of fair value. The Commission might consider similar guidance with respect to Item 402(c) as well as proposed Item 402(v).

Emerging Trend of Considering Other "Stakeholders"

In recent years, there has been a push for corporations to directly consider the benefit of "stakeholders" other than shareholders (e.g., customers, employees, suppliers, community, etc.). This has been reflected in a 2019 Business Roundtable statement signed by many CEOs that purportedly committed to running companies for the benefit of all "stakeholders." There appears to be an underlying premise of this "stakeholder" focus that there is a conflict between creating shareholder value and the treatment of others. While I find this premise dubious (i.e., the benefit of shareholders depends on the benefits of these other constituents), there has been a significant amount of influence on executive compensation. Specifically, there has been a push for performance metrics that are not directly linked to shareholder performance.

Accordingly, if there is some acceptance of the premise that there is a conflict between shareholders and other "stakeholders," then it would make sense that the shareholders ought to understand the costs associated with providing these benefits (i.e., to placate some constituents, shareholders might have to accept a lower rate of return on their investment). The final pay for performance rules should permit (but not require) companies to provide an estimated cost to shareholders for performance measures that are believed to negatively impact shareholder values. As with other executive compensation disclosures, these should be principles-based and might include tabular disclosure and/or narrative disclosure.

* * *

I hope that the Commission finds these comments helpful. If anyone at the Commission would like any assistance or would like to discuss any of these comments with me, I would be delighted to do so.

Sincerely,

Andy Restaino
Managing Director