



March 4, 2022

The Honorable Gary Gensler, Chair
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Rulemaking Proposal on Pay-Versus-Performance Disclosure

Dear Chair Gensler:

I write to offer input in connection with the SEC's rulemaking on Pay-Versus-Performance Disclosure under Section 953(a) of the Dodd-Frank Act. I have studied these topics in my academic work, and some of my comments draw on published research, as noted below.

General Observations

1. The Recent Evolution of Executive Compensation Practices

The pay-versus-performance disclosure mandate adopted by Congress in 2010 refers only to *financial* performance. Since then, however, we have witnessed an evolution in incentive-based compensation practices, with firms increasingly considering both financial and non-financial performance in setting executive compensation. Given these developments, the SEC's pay-versus-performance disclosure rule (the "Rule") should be careful to avoid painting a skewed or incomplete picture of firms' executive compensation arrangements. In practice, this means that the Rule should require information about *both* financial and non-financial performance measures (if any) that a company uses to determine incentive-based executive compensation.

It is worthwhile to elaborate on the growing use of non-financial performance measures. A recent study showed that more than half of S&P 500 companies have incorporated ESG metrics into incentive-based compensation plans; this includes both climate-related metrics and metrics related to human capital management (HCM).¹ A different study focusing on the largest 100 public companies found that 41 incorporate ESG metrics into their executive compensation programs.² Among those companies, 33 incorporate ESG metrics into a holistic qualitative review of individual performance (using different weightings and approaches), whereas 8 include ESG as

¹ Willis Towers Watson, *ESG and Executive Pay* (2021), at 18, <https://bit.ly/3Ko5jDT>.

² Shearman & Sterling, *Corporate Governance & Executive Compensation Survey 2021* (2021), <https://bit.ly/3CppNt6>.

an individual metric.³ There is considerable heterogeneity and practices are evolving fast.⁴ In addition to ESG metrics, incentive-based executive compensation plans also incorporate other non-financial metrics, such as operational metrics.

2. Potential Behavioral Effects and the Importance of Proper Framing in Rule Design

Depending on their framing, disclosure rules can have behavioral effects—i.e., in addition to providing information, the rules may also influence substantive corporate behavior.⁵ In the case of the pay-versus-performance rule, an exclusive focus on disclosing the link between executive pay and *financial* performance measured through total shareholder return (TSR) may lead firms to change their compensation programs to prioritize this link. Such changes may occur irrespective of a board’s considered judgement about the optimal arrangements for a particular company, and they may come at the expense of linking executive pay to *non-financial* performance measures, or even to measures of financial performance that do not track TSR.

There is no evidence that in adopting Section 953(a) of the Dodd-Frank Act, Congress sought to encourage firms to change their compensation practices to link pay to financial performance, or to prioritize financial performance over non-financial performance. In other words, there is no evidence that Congress intended for the Rule to fulfill any function other than a purely informational function. As a result, the SEC should be careful not to design the Rule in a way that implies that pay-for-financial performance (measured through TSR) is the best way to structure an executive compensation program. As discussed further below, the tabular format should not become a rigid template and firms should be encouraged to vary or supplement the proposed table as appropriate. A uniform template has advantages when the underlying information is directly comparable across firms and over time, but in the case of pay-versus-performance disclosure, the information is too noisy and firm-to-firm comparisons should be discouraged, not encouraged.

Specific Comments

3. “Five Most Important Company Performance Measures”

I support the proposal to require disclosure of the “most important company performance measures.” Indeed, disclosure provided under the Rule would be incomplete and potentially misleading without this information.⁶ This new requirement marks a significant improvement over the SEC’s 2015 Proposing Release, but its content still needs to be refined.

³ *Id.*, at 25.

⁴ See, e.g., John Ellerman, Mike Kesner & Lane Ringlee, Pay Governance, *Inclusion of ESG Metrics in Incentive Plans: Evolution or Revolution?* (March 16, 2021), <https://bit.ly/35YctzO>.

⁵ See Steven A. Bank & George S. Georgiev, *Securities Disclosure as Soundbite: The Case of CEO Pay Ratios*, 60 B.C. L. REV. 1123, 1146-50 (2019), www.ssrn.com/id=3324882.

⁶ While it is true that the existing CD&A rules require a discussion of all material elements of the company’s executive compensation, this discussion is prospective and conceptual. A discussion of the link between actual NEO pay and actual performance (as determined pursuant to the company’s chosen

The Rule should not be limited only to the five most important company performance measures, as currently proposed. Instead, the Rule should require that registrants list *all* performance measures that have had a significant role in determining NEO pay. The number of these measures could be less than five or more than five—the Rule should not impose an arbitrary cut-off. Formulated this way, the new disclosure will provide a clear historical view of (1) how the board conceptualized and measured company performance for compensation purposes, and (2) how the board linked executive pay to company performance (as it understands it). This information is material to investor voting decisions on director nominations, say-on-pay, and compensation-related shareholder proposals. Requiring the disclosure of all performance measures that have had a significant role in determining NEO pay solves the problem of how to define “most important” for purposes of coming up with the “five *most important* company performance measures” (Question 5). To avoid ambiguity, the term “company performance measures” should be defined clearly to cover *non-financial* performance measures.

In addition to listing the company performance measures, the Rule should also require that registrants specify whether the link between a particular measure and pay was discretionary (i.e., a non-binding factor in the board’s decision regarding pay) or automatic/non-discretionary (i.e., a pre-determined benchmark in the compensation formula). Finally, the Rule should also offer guidance on what constitutes a “performance measure”; presumably, the concept will capture both hard/numerical measures and softer/qualitative measures. The specificity with which registrants disclose a particular performance measure should match the specificity with which this performance measure is incorporated in incentive-based compensation plans, with a carve-out for commercially sensitive information.

4. Additional Financial Measures

The 2015 Proposing Release was right to select TSR as the appropriate measure of financial performance given the prescriptive statutory language of Section 953(a),⁷ and the fact that registrants already calculate and report TSR under Item 201 of Regulation S-K. Nevertheless, TSR is an imperfect measure of financial performance in the pay-for-performance context.⁸

measures) during the specified historical period would offer new information that is material to investor decisionmaking. We can expect that the actual performance measures disclosed by registrants will encompass both financial and non-financial measures, including operational measures and ESG measures.

⁷ Section 953(a) refers to “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*” (emphasis added).

⁸ By definition, TSR is measured over a one-year period, whereas compensation actually paid for the same year includes compensation that was awarded in prior years for performance in those years. This is a function of the unavoidable complexity of modern pay practices. What is more, TSR is a backwards-looking measure and may not be useful in assessing how well a company is performing in areas that will determine its long-term value and success. Measuring financial performance using TSR disregards the diversity in corporate strategies and the fact that some boards may prioritize the interests of long-term shareholders over short-term shareholders, or that they may choose to take into account the interests of non-shareholder constituencies. See Steven A. Bank & George S. Georgiev, *Paying High for Low Performance*, 100 MINN. L. REV. HEADNOTES 14, 18-20 (2016), www.ssrn.com/id=2641152.

Given TSR's limitations, it is understandable why the 2022 Release seeks input on adding additional financial measures, such as pre-tax net income and net income (Question 1). The SEC should reject this idea. Adding pre-tax net income and net income to the pay-versus-performance table will not solve most of the problems associated with TSR, and it creates an important additional problem: it overemphasizes financial performance. By listing four financial measures (TSR, pre-tax net income, net income, and, potentially, a company-selected (financial) measure), the pay-versus-performance table will train investors' attention firmly on *financial* performance. In doing so, it will privilege management strategies that align pay with (short-term) financial performance over management strategies that align pay with a more capacious understanding of performance, which may, for example, also include longer-term financial performance and non-financial/ESG performance. The point here is about the framing of information and the legitimization of one set of compensation strategies over another, rather than about the availability of information, because pre-tax net income and net income are already available on firms' financial statements. If investors find those (or other) accounting measures relevant for purposes of assessing pay-for-performance, they can easily obtain the information from the financial statements and incorporate it into their analyses.

Finally, I support the addition of a "company-selected measure" to the pay-versus-performance table, subject to certain qualifications. The "company-selected measure" should be a *financial* measure, and it should be presented as an alternative to TSR (Question 7). The company-selected financial measure would be an opportunity for registrants to include pre-tax net income or net income, if relevant, or to present TSR calculated on a different time horizon (Question 21). Additional flexibility here is warranted: Registrants should be allowed to omit the "company-selected [financial] measure" if there isn't a single measure used to assess financial performance for compensation purposes, or to include more than one "company-selected [financial] measure," if relevant.

5. Peer Group TSR

The 2015 Proposing Release suggested including "peer group TSR" in the pay-versus-performance table. The Proposing Release did not state clearly the justification for this, though presumably it was to encourage comparisons in financial performance between the registrant and its peer group. I believe that the "peer group TSR" column should be omitted from the Final Rule for the following reasons: First, Section 953(a) does not require peer group performance information or any other comparative information. Second, "peer group TSR" is already disclosed elsewhere in the proxy statement pursuant to Item 201 of Regulation S-K, and investors who find this information relevant to their decisionmaking can obtain it easily. Finally, including "peer group TSR" in the table may be taken to imply that incentive-based compensation should be a function of a firm's TSR relative to the TSR of its peer group, or, in other words, a function of a firm's short-term financial performance relative to the short-term financial performance of its peer group. This may make it more difficult to put in place compensation arrangements that link pay to measures of performance other than short-term financial performance. In short, the inclusion of peer group TSR in the table encourages comparisons based on very noisy information and in an area where such comparisons would not be warranted even if the information were more meaningful.

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I commend the Commission and the Staff for working to complete this rulemaking under the Dodd-Frank Act, and I appreciate the opportunity to submit comments for consideration. I would be happy to discuss any of the points raised herein at your convenience.

Sincerely yours,

/s/ George S. Georgiev

George S. Georgiev
Associate Professor
Emory University School of Law

cc: Hon. Caroline Crenshaw, Commissioner, U.S. Securities and Exchange Commission
Hon. Allison Herren Lee, Commissioner, U.S. Securities and Exchange Commission
Hon. Hester Peirce, Commissioner, U.S. Securities and Exchange Commission