



July 2, 2015

Mr. Brent J. Fields

Secretary

Securities and Exchange Commission

100 F. Street, NE

Washington, DC 20549-1090

Re: File Number S7-07-15, Disclosure of Pay for Performance

Dear Mr. Fields,

I am writing on behalf of Hodak Value Advisors, LLC. We advise investors and boards on performance measurement, incentive compensation, and related governance issues. I have worked with client firms on these matters for over 20 years. I have also taught corporate governance at the New York University's Leonard N. Stern School of Business for the last ten years, and address director groups and institutional investors around the country. In addition to our work advising companies, we conduct and review research to better understand the impact of compensation structures on shareholder value. This research both supports our client work, and is used by securities analysts and asset managers to determine the quality of executive pay at firms in which they invest.

In this context, we respectfully offer our views on rule changes mandated by Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, as proposed in the SEC Release No. 34-74835. This letter will generally address your requests for comments regarding questions 21 through 46 from the Release.

SEC proposal, “actually paid,” and cumulative TSR

We will focus our comments on three items from the Commission's proposal:

1. Pay-for-performance disclosure would be rules-based, with “pay,” “performance,” and their presentation prescriptively defined;
2. “Pay” is defined as salary, plus bonus, plus the value of vesting equity, plus the service cost of pensions, plus all other compensation;
3. “Performance” is defined as cumulative total shareholder return (TSR) over each of the prior five years (three years for smaller companies) and relative to the cumulative TSR of a peer group (for the larger companies) over the same periods.

The Commission's use of vesting value of equity instead of the grant-date value of equity (i.e., per the Summary Compensation Table, or SCT) and pension service cost instead of the full change in pension value (also per the SCT) is based on its interpretation of compensation “actually paid.”

The proposed standard of performance—cumulative TSR—is calculated from the last day before the first fiscal year shown on the proposed table (five years back for large firms; three years back for smaller firms). If our interpretation is correct, this means that annual pay will generally be compared to multi-year TSR of various durations. In other words, a firm reporting for FY2015 would compare 2015 pay to five-year cumulative TSR from the end of FY2010 through the end of FY2015; 2014 pay would be compared to the four-year cumulative TSR from the end of FY2010 through the end of FY2014, etc.

Before discussing the proposed disclosure and our comments, it is helpful to distinguish “pay-for-performance” in the context of what will follow.

Why investors care about pay-for-performance

Boards make choices about how to pay their executives. Investors expect them to make those choices in favor of plan structures that do three things at the same time:

- (a) Attract or retain the managers they need,
- (b) Enhance the alignment of interests of managers and shareholders, and,
- (c) Achieve retention and alignment goals at a reasonable cost.

In order for investors to judge if those objectives are being met, they need to know not just whether costs actually *paid out by the company* are associated with performance, but if the company-derived pay ultimately *received by management* rewards them for, and thereby encourages, shareholder value creation. In other words, investors use pay-for-performance to both **benchmark costs** and **judge alignment**.

While these motivations are not entirely independent, they are distinct. Consider two firms: Company A pays its CEO \$1 per year, while Company B grants its CEO \$1 million in shares of restricted stock per year. Regardless of how one determines pay, the CEO of Company A is clearly a better ‘deal’ than the CEO of Company B in terms of cost. However, the pay of Company B’s CEO provides much greater alignment with shareholders, while Company A’s pay provides no alignment whatsoever.

If we are primarily concerned with pay as a cost, then our definition of pay should focus on how much *the company is giving up* in employing the executive. Such a definition of pay is already estimated in the compensation figures shown in the SCT. While there is a legitimate debate over whether the real “cost” of stock awards should be based on grant date or vesting date values, it seems illogical to count shareholder “cost” one way in one part of the proxy, and another way in another part of the disclosure.¹ This also applies to how one might determine the cost of pension benefits.

¹ The “cost” of equity pay can get nuanced. If the company issues restricted stock, its “cost” is best expressed as the value of the shares at the time of grant, not when restrictions are lifted, since post-grant stock movements create neither cost nor income for the company. If the company awards RSUs, then “cost” would be the share value at vesting, when the company turns the units into shares. Economically, both transactions look the same to the executive, but the “cost” looks different to the firm. On the other hand, while granting or vesting of options creates an economic cost to the company, the shareholders do not in any or legal or accounting sense incur compensation cost at the time of vesting. Their cost is actually incurred at the time of exercise, when the company settles with the employee the difference between the value of the stock and the exercise price.

If we are primarily concerned about alignment of interests, then our definition of pay should be based on changes in the total value of company-derived wealth *received by the executive*. In theory, this “pay” would account for the executive’s entire holdings of vested equity, and at least some recognition of changes in the value of unvested equity from the time it is granted, since all exposure to the company’s stock price contributes to alignment.

Although investors focused on shareholder value gains generally appreciate the power of alignment at least as much as they worry about cost, it seems plain both from the legislative history behind Sec. 953(a) and the current proposal that this disclosure is intended to be primarily an exercise in costing. Nevertheless, if a basic question is how this rule will serve investors, we must acknowledge the benefit of their ability to discern both cost and alignment.

Where this method yields sensible results

The proposed rule for determining pay-for-performance will provide meaningful information to investors as long as (a) any bonus plan consists of cash awarded each year consistently based on a share of, or share of the change in, some measure closely related to shareholder value (e.g., a “profit sharing” or “value sharing” plan), or (b) the company grants a significant, one-time, up-front equity award that vests in equal installments over the full five-year period.

While most companies seek to offer bonuses based on factors that reasonably track, if not drive, stock price over time, very few stocks will perfectly reflect accounting-based performance (e.g., net earnings, ROIC, economic profit, etc.) given the lags, uncertainties, or inherent incompleteness of the relationship between accounting-based and market-based measures. Nevertheless, any well-tailored measure of profit used in a value-sharing plan is likely to yield a reasonably good pay-for-performance relationship over a five-year period according to the proposed rule. If the performance measure *were* the stock price, and the target bonus remained constant, then the bonus plan would look like (and pay out exactly like) equal vesting shares from an up-front grant.

We note that an up-front grant with equal vesting over five years would yield a perfect correlation between actual pay, as proposed, and cumulative TSR, in every year of the disclosure. Although this perfect correlation does not necessarily reflect perfect pay-for-performance from an investor’s perspective, it does provide a reasonable relationship between pay and performance for both “cost” and “alignment” purposes, and would do so based on either annual or cumulative TSR results.

Four ways the proposed rule could mislead investors

While profit- or value-sharing incentives and up-front grants of equal-vesting equity have a lot to recommend them, the vast majority of cash bonus or equity award plans don’t look like those, nor are they necessarily optimal or appropriate for every company.

Instead, companies offer bonus plans based on single measures, multiple measures, non-financial measures, or no formal measures at all (i.e., subjective plans), as well as plans that pay out in equity as well as cash, and plans that do so based on performance over one or several years. Whether based on service or performance, companies award equity throughout their executives’ tenures, grant them irregularly, vest them unequally, settle

them in cash or shares, and offer them to different executives at different times in different amounts, depending on when they were hired or promoted or last pursued by a competitor. Any of these varied plan designs might serve shareholder interests by enhancing retention or alignment in a reasonably cost-effective manner, but their value in doing so may be lost in a comparison of actual pay versus cumulative TSR based on the proposed rule.

Here are four general ways the proposed rule could distort investors' view of pay-for-performance, either by making reasonable pay-for-performance look bad, or by making poor pay-for-performance look good.

1. *If managers are granted equity each year, then during a **ramp-up period**, vesting equity will inevitably increase “actual pay” regardless of performance.*

Relatively few public companies provide large, up-front awards intended to last up to five years. Most provide annual grants of equity, with each grant vesting over multiple years. Consider a company that grants 40,000 shares each year with vesting over four years. At the end of the first year we would see 10,000 shares vesting. At the end of the second year, another 10,000 shares would vest, plus the first 10,000 shares from the second year's grant, making a total of 20,000 vesting shares. The third year will then see 30,000 shares vesting. Only from the fourth year onward would we see 40,000 shares per year vesting, and the values of the vesting shares more or less tracking the value of the stock. In the three years before reaching that steady state, the proposed rule will almost invariably make pay look like it is significantly growing regardless of performance.

In any given year, about one-third of CEOs have been in place for fewer years than their firm's average equity vesting period. For those firms that are granting equity each year, investors are likely to be misled by the proposed disclosure in any period where the stock price happens to be stagnant, declining, or otherwise not keeping up. This problem becomes more acute with the use of cliff vesting, whereby all equity from a particular grant vests at the end of the service period, e.g., three years. This problem becomes even more vexing for firms that offer irregular equity grants, which may sometimes be warranted.

In fact, we estimate that fewer than one-third of firms in the public company universe ever reach a “steady state” with regards to equity vesting over five consecutive years for their top executives. During that period, companies are likely to introduce or phase out incentive programs such that significant differences in the value of vesting equity may arise for purely for programmatic reasons.

2. *Even with up-front grants, the proposed disclosure may yield **path-dependent** outcomes that may distort pay-for-performance from an investor's perspective.*

If two companies had identical compensation plans, with identical equity grant practices, and identical TSR over a five-year period, how should investors interpret very different levels of “actual” pay? Far from an exotic possibility, this outcome would be normal using the proposed rule.

Consider two companies that each award an up-front \$3 million grant of restricted stock with four-year vesting to their respective CEOs, and grant no more equity

afterward (so there is no ramp-up effect). Let's say that in both cases, the stock increases 50 percent, from \$20 to \$30 per share, over five years. Note that if both CEOs keep all of their shares until the end of the five-year period, they will each have earned exactly \$4.5 million from their original award.

But let's say that Company A sees its stock price dip to \$12 per share before recovering to \$30, while Company B sees its stock price rise to \$45 before falling back to \$30. Under the proposed disclosure, Company B will have "actually paid" its CEO over \$5 million across the five-year period while Company A would have "actually paid" about \$2.5 million—half as much as Company B. (See Table 1 for a numerical illustration.) This effect would be even more pronounced when using stock options.

Although the amounts noted in this example are arguably valid representations of what each CEO was actually paid, and would in fact equal what each CEO realizes from their respective companies if they instantly cashed in their vested shares, what does it tell shareholders that one CEO got half as much as the other for the same overall TSR performance over that period? Investors looking at the proposed disclosure could easily attribute the difference in actual pay to differences in compensation plans, even though their plans were identical. It is likely that, based on the proposed disclosure, investors would interpret the higher paid CEO as "overpaid" relative to their peer CEO as a result of board level decisions regarding pay, even though both boards made exactly the same decisions.

The Commission's proposal places a heavy emphasis on comparability across firms. But the circumstance outlined above would show two firms with exactly the same performance over time, exactly the same compensation plans, and probably very similar pay outcomes from the perspective of the executives, but with wildly different pay-for-performance because of different patterns of stock price growth. While the stocks of firms in any given industry will move together to some extent, every firm will have significant differences in their pattern of returns. And if such a plan has equal vesting over all five years, the proposed rule will put a false stamp of validity to the illusory divergence in pay outcomes by showing a perfect correlation between actual pay and cumulative TSR in each year. (See Table 2 for a numerical illustration.)

3. *Conversely, the proposed disclosure could **disguise the lack of alignment** between management and shareholders.*

In some instances, particularly with annual, fixed-value grants of equity, two companies with otherwise similar compensation programs may end up awarding highly unequal numbers of shares or options based on the path of the stock price over time, but the proposed disclosure will make it look like they had the same pay for the same performance.

Consider, for instance, two companies each granting \$1 million per year of a mix of restricted stock and options to their respective CEOs with four-year vesting. Each year, as the stock price goes up or down, the amount of shares or options is adjusted to provide a \$1 million award. Let's say that one company sees a decline of 40% before a rebound to 50% above the starting price, while the other sees a steady

increase in the stock price up to 50% above the starting price. Investors end up in the same place—50% above the starting point. All else being equal, investors might expect management to earn roughly the same at both companies over that full period.² The proposed disclosure would in fact show both companies having similar pay-for-performance, which would be the actual result if the CEOs sold their equity immediately upon vesting. However, to the extent they kept their equity until the end of the period, the executives of the company with more volatile results would end up with up to twice as much wealth. (See Table 3 for a simplified illustration.)

The current and the prior examples illustrate the tension between determining actual pay as the cost borne by the company versus as pay ultimately received by the management. The proposed method of only counting vesting equity would, in the current example, show CEOs of two companies appearing to make about the same, based on what is paid out, but in fact ending up with very different company-derived pay, disguising a significant lack of alignment. In the prior example, CEOs of two companies appear to be paid very differently, but in fact ended up with similar pay, and therefore similar pay-for-performance alignment. Such distortions would not matter if they resulted from unlikely scenarios, or if only the “cost” version of pay mattered to shareholders. But investors very much care about both kinds of pay. And distortions resulting from share price swings from year to year are universal—only the degree varies among firms.

Finally, while the examples above discuss time-based equity awards, the conclusions largely hold for performance-based equity, as well. Performance-based *grants* have exactly the same ramp-up and path-dependence issues noted in prior examples. Performance-based *vesting* adds a layer of complexity, and therefore uncertainty, with regards to both actual costs and what executives actually earn from their employment. The simplest case is a target award of stock whose vesting is based on, say, earnings growth. Mathematically, this is identical to a bonus plan based on earnings, that pays out in stock instead of cash. If the performance measure closely tracks TSR, then the proposed disclosure is likely to reflect pay-for-performance in a meaningful way. If the performance standard *is* the stock price, then performance-based stock awards would mathematically mimic time-based option grants, and should lead to reasonable pay-for-performance under any definition of pay.

However, most performance-based equity plans have more discrete vesting conditions, such as a minimum level of achievement that triggers the vesting of a significant equity award. Since the bump in pay would presumably be performance-based, we might expect annual pay and cumulative performance to be better correlated than with time-based vesting. But when you model this relationship, including the fact that falling short of target by one dollar might yield a zero award, you actually get a more exaggerated pay-for-performance pattern that does not significantly overcome the ramp-up and path-dependence issues raised above.

² If investors had to choose which management should get paid more, they would probably prefer it to be the management of the company with less volatile results. The fact that the opposite is true creates an interesting, but different point regarding compensation and risk.

4. *The proposed disclosure completely ignores equity gains before vesting, which represent real value to the executive, and are therefore important to the investors.*

The release discussed the potential benefits of including the value of equity from the time it is granted, plus any interim changes in value until the time it is vested, as part of compensation “actually paid.” Those benefits include improving the comparability of pay, eliminating major differences in pay due to slight differences in the timing of vesting, and providing a more accurate picture of the sensitivity of pay to performance. The potential distortions of the proposed rule are simply the inverse of these benefits, so not worth rehashing in detail, but well worth re-iterating.

These distortions would be significant and widespread among public companies. In every sector, wherever equity is a significant portion of compensation, and wherever extended vesting is used as a retention or alignment tool—which is almost everywhere—investors will see pay variations that are misleadingly discontinuous over time and mismatched with regards to timing. For the average company, where upwards of 80 percent of the real variation in the value of pay would derive from unvested equity, especially for companies with newer executives, it is difficult to countenance such a distortion.

The rationale for rejecting inclusion of the change in value of unvested equity is that it would be burdensome to require companies to revalue their equity awards each year. We disagree that this would necessarily be burdensome. We are able to easily track our clients’ unvested equity values in real time. The burden of such disclosure would be largely due to a requirement to “file” rather than “furnish” this information to the government. By having to file it, any software that tracks these changes will need to go through an additional layer of review for accounting and controls, and additional legal risk would accompany their inclusion in the tables. We acknowledge this concern, and will address it in our recommendations below.

Some unintended consequences that the proposed rule would likely encourage

Pay-for-performance is significantly about incentives. SEC rules themselves create powerful incentives, and have driven huge changes in pay programs over the last several decades, some of which, though unintended, were predictable.³

We can predict a number of changes in corporate policy that would likely arise from the proposed disclosure:

1. *A greater emphasis on **short-term** performance.*

Annual bonus plans provide more control over pay outcomes and, therefore, under the proposed rule, less risk of a mismatch in pay versus performance, than long-term incentive plans. This may encourage a greater proportion of variable compensation awards coming from annual bonus plans. That would be fine if annual plans tended to be of the “sharing” variety noted earlier, but they aren’t. The vast majority of annual plans are budget-based, whereby each year the board determines specific measures and targets for compensation purposes.

³ See Hodak comment letter of April 10, 2006, where we believe our four predictions in that note have been largely borne out.

Nothing says “gun it for the short-term” like a bonus plan whose measures and goals turn into pumpkins at midnight on the last day of the fiscal year, with management knowing that new goals for the following year are yet to be determined. Public companies already have many factors that compel a short-term focus. The typical, budget-based incentive plan reinforces this behavior in numerous ways. Even budget-based *long-term* incentive plans create a similar short-term focus to the extent that roughly one-third of potential LTIP awards are based on what is, at any given time, current end-of-fiscal-year metrics and goals.

2. *A reduced emphasis on equity awards.*

As mentioned earlier, variable compensation plans that utilize up-front equity grants could work well under the proposed disclosure. But plans that vest equity awards over time may yield highly uncertain results under the proposed disclosure based on stock price fluctuations over time, and the path-dependence they create. Companies can eliminate most of that uncertainty by making awards in cash instead of stock. Alternatively, they may begin awarding immediately vesting stock with mandatory holding periods to minimize that uncertainty.

In contemplating such a shift, consider that equity can be both a *reward* for achievement of value creating goals, and an ongoing *incentive* that aligns the interests of management and the shareholders. As a *reward*, equity is granted at the end of a plan period, when performance relative to goals is known. As an *incentive*, equity is granted at the beginning of a plan period such that management is exposed to the future ups and downs of the stock price.

In comparing only the vesting value of equity to historical TSR, the proposed disclosure implicitly recognizes equity as a reward for past performance while ignoring its potential to create further alignment as long as the shares are held after vesting. The proposed disclosure also ignores any alignment created by unvested equity, whose value most executives at least partially consider, to the benefit of investors. In fact, the research is clear that greater management stock ownership leads to better company performance. Ignoring the impact of equity in these ways while potentially penalizing their use may drive a reduction of their use in pay, and the alignment they create.

3. *Greater use of stock-based metrics driving variable compensation*

Even as companies reduce stock as a reward, they may increase the use of stock price as a basis for making awards. Since the proposed disclosure uses TSR as the standard against which to measure pay, companies will have an added reason to use their stock price as a measure upon which to base variable compensation.

TSR is unquestionably the single most relevant metric for investors. Over time, it is the ultimate indication of shareholder value creation, and the basis upon which investors themselves are generally measured. It also happens to have the virtue of being universally comparable across companies and sectors and over time.

But TSR is an awful management metric for year-to-year performance. Few managers, right up to the CEO, feel that they have much effect on the stock price, even over multiple years. And they are right; research suggests that the sum of managerial

actions—R&D investments, pricing decisions, supply chain management, etc.—generally drive less than one-fifth of the variation in stock price in a given year, the rest being due to external forces beyond their control. The easiest ways for management to directly drive their stock price in real time are practices nobody wants management to indulge in—e.g., the strategic release of company news, deferred maintenance to save on expenses, accounting judgments that push the boundaries, etc.—all of which behaviors are largely unobservable to the board, until their effects become visible to everyone, which increases the firm’s governance risk.

It is far better to reward management against accounting-based metrics that presumably represent value creation, and to which managers have a clearer line of sight. Managers are generally comfortable focusing on tangible operating results in the faith that improved profitability over time will eventually be reflected in the stock price. Their investors are generally comfortable with that, as well.

Better alternative in calculating actual pay for determining alignment

By being conscious of the role that variable compensation plays in creating alignment, as well cost, we can derive an improved method for determining “pay” that avoids the potential ramp-up, path-dependence, and other distortions of the proposed rule.

As already noted, the “pay” most appropriately compared to performance in determining alignment would equal the change in the executive’s company-derived wealth. That would include the sum of: The value of equity granted during the fiscal year, plus the change in value from the time of grant to the end of the fiscal year, plus the change in value of all other equity that the executive held from the beginning of the fiscal year. For instance, consider an executive who goes into the year with 100,000 shares of vested and unvested stock. That year she vests in 20,000 shares, while the stock goes from \$15 to \$20, and is awarded 30,000 shares in new restricted stock. In this case, that executive’s pay would equal \$1,100,000, i.e., 30,000 shares x \$20/share in new awards, and 100,000 shares x \$5 increase in stock price for shares held from the beginning of the year. (The 20,000 vesting shares simply changes a portion of that 100,000 to vested from unvested). That \$1.1 million, and whatever that figure grows or shrinks to over time, can be meaningfully compared to the company’s performance each year, or over multiple years, without any concern that the form or timing of compensation, or pattern of stock price would distort the results.

Mathematically, this method can result in negative pay. While this may seem anomalous, it is, in fact, perfectly reflective of pay-for-performance in the sense of understanding alignment. The reason entrepreneurs who make \$1 a year are well-aligned with their co-investors is because their personal fortunes go up and down with the value of their companies, and can potentially go negative relative to the prior value of their firms. From an alignment perspective, for instance, it is (or should be) far less relevant to Dish Network’s investors that Charles Ergen made \$2 million in salary and equity grants (or \$2.4 million based on vesting shares) per year than that he is making or losing an average of \$150 million per day⁴ from the movement of his stock.

⁴ Based on the standard deviation of the firm’s TSR.

We grant that calculating year-end equity values each year is potentially burdensome for companies, or that it may be more burdensome for some firms than others. Nevertheless, we suggest that if the Commission requires an annual measure of “pay” for determining alignment, it should include the change of wealth as outlined above. If the Commission decides not to require a change-in-wealth measure universally, which would perfectly understandable given its novelty, it should at least allow firms willing to bear that burden to include this element of pay as part of “actual pay.” The potential objection that such an allowance would undermine comparability of pay across companies is inapt; the current proposal would show dramatically different levels of actual pay among otherwise identical pay plans by excluding this adjustment. In other words, we believe that the proposed rules begin with a lack of comparability that we are proposing to fix.

Under this alternative method of determining actual pay, we would only calculate it for CEOs and NEOs that have been in their positions for at least a full year, or who departed in the last year. Investors would learn nothing regarding the alignment of executives who have been in place less than a year given the noise in TSR for such a period; therefore, companies should not be wasting time and money calculating the change in wealth for such executives. It would be more meaningful in the evaluation of a compensation program to be able to look back for up to five years, even with regards to people who left, in determining how well aligned executives are with their shareholders.

Better alternative in calculating actual pay for determining relative cost

If the Commission decides that alignment is not an important consideration, and wishes to continue focusing on cost, then we would suggest a couple of modifications to the proposed calculation of actual pay to greatly reduce the distortions we outlined.

We can virtually eliminate the ramp-up issue by calculating actual pay, as proposed by the commission, over the full tenure of the executive. This would include all of the cash and vesting value of equity since the executive was hired. To complete the calculation, one should also include the severance amount at the end of the most recent fiscal year, e.g., the potential cost associated with dismissal without cause, which is already calculated under Payments upon Termination, or the actual amount paid, if the CEO left before the end of the fiscal year.

For instance, let’s say that an executive has \$1 million in vesting equity, and \$2 million in unvested equity, half of which would vest upon dismissal without cause. These two components would add up to \$2 million toward the calculation of actual pay, i.e., the vesting plus termination payments. The following year, let’s say another \$1 million of equity vests, and the executive is granted another \$500k in restricted stock, ending up with \$1.5 million in unvested equity, half of which would vest upon termination. This would add up to \$1.75 million toward the calculation of actual pay. This pay result—or an annualized version, for comparability across firms—would provide investors a reasonable data point for comparison to performance over that same period (also annualized).

A tenure-length measure could also overcome the key limitation of TSR as a measure, i.e., that shorter periods don’t provide enough time to confidently attribute company performance to managerial action. As we noted earlier, over 80 percent of a typical company’s stock price variation in any given year is driven by external factors, e.g.,

industry-wide trends, political uncertainty, etc. However, since those external factors are somewhat random in their effect over time, management's relative contribution (which is presumably non-random) increases with the length of the evaluation period. The longer the time horizon, the more we can hold management accountable for their stock price performance.

In theory, this problem can be somewhat remedied by looking at pay versus relative performance against peers. This helps to isolate the effect of management versus industry-wide forces. However, there are a number of practical problems with finding suitable peers for multi-year comparisons.

In order to create value, a company must differentiate itself from its competitors. Consequently, every company will differ in their composition of assets or operations in a way that, by design, will create at least some lack of comparability to their peers. The best that one can hope for in identifying peers is significant overlap in their business model or their product markets. For some company pairs, the overlap might be (qualitatively) 75 or 80 percent. For others, it might be 40 or 50 percent. For larger companies, which are basically agglomerations of different businesses, there will invariably be significant differences among firms. Smaller companies fight just as hard to distinguish themselves in their respective markets, and have peers that regularly appear and disappear due to start-up or M&A activity. All of this is true whether we are talking about peers in the competition for management talent, or in the competition for product or capital markets, which can arguably be different.

Many companies do not pay their executives based on relative performance precisely because the standard of relative performance can be very difficult to objectively ascertain, and even more difficult to maintain over an extended number of years. That is why most long-term incentive plans based on relative performance continually wrestle with periodic revisions of their peer groups.

Under this alternative method of calculating actual pay, we would only do so for CEOs that have been in their position for at least a full year, or who departed in the last year. As noted earlier, there is little to be learned by comparing pay to performance of less than a year. We also believe that companies should not be required to provide this pay data for NEOs at all. Annualized, tenure-length pay would be burdensome to calculate for every executive, especially since it would involve different performance periods for each executive, risking confusing investors. From our perspective, 953(a) was almost entirely motivated by headline concerns about CEO pay. We do not believe that there is sufficient general concern about the pay of non-CEO executives that is not otherwise reflected in how CEOs are paid.

Alternatives in calculating performance

As indicated earlier, using TSR as a performance measure comes with significant drawbacks, including the poor line-of-sight between managerial performance and the stock price, the dominant impact of non-managerial factors on stock price over periods less than five years, the short-termism and governance risks induced by too much attention on stock price over short periods, and the significant limits in comparability versus peers over longer periods. Looking at TSR over the tenure of an executive provides an opportunity to sidestep the worst of these problems. For CEOs that have been

in their jobs for a while, e.g., more than four or five years, TSR can begin to look like an appropriate gauge of performance.

Nevertheless, given the limitations of TSR and relative TSR as measures of management performance, it's worth considering comparing actual pay (either the 'alignment' or 'cost' version) against an accounting-based measure, such as profit, return, or other metric that the company believes is a relevant proxy for shareholder value. Investors will no doubt continue to look at TSR in comparing pay to performance, so it would remain up to the company to defend the metric, and explain why it might not be tracking the stock price over one or several years.⁵

The obvious objection to non-stock price measures is that one measure cannot apply to all companies, sometimes not even within an industry, and thus allowing each company to choose its measure(s) would undermine comparability across firms. Still, for the sake of alleviating the above drawbacks, firms should be able to disclose their performance, and that of their peers, using an accounting-based measure as well as TSR.

For reasons stated above, firms should not necessarily be required to supply peers for the purposes of determining relative performance. They should be allowed to do so, but many companies do not compare themselves to peers for any purpose, including performance, and there may be no objective way for peers to be determined. Forcing them to develop a peer list would be costly, with no evidence that it would help investors.

And it is totally unnecessary. Investors already track relative performance, many of them with the tools that enable them to instantly alter or tailor their peer lists.

Recommendations for improving pay-for-performance disclosure

It seems plain to us that despite all of the discussion and input thus far on pay-for-performance, notwithstanding our convictions laid out in this letter, there remains a significant lack of consensus based on honest differences of opinion about how to measure "pay" and, to a lesser extent, how to measure "performance." We believe that much of this lack of consensus arises from a failure to distinguish *why* one might inquire into pay-for-performance; are we trying to help investors understand their firm's compensation cost, or the degree to which their managers' interests are aligned with the shareholders'?

If the Commission feels compelled to implement a rules-based disclosure, then it should require meaningful new information that minimizes distortions in the evaluation of pay-for-performance. We believe this can be accomplished in one of two ways, depending on whether the Commission intends to support an analysis of cost, or of alignment.

⁵ Interestingly, in contrast to the proposed SEC performance standard of TSR, Bloomberg recently announced that they are using an accounting-based measure of performance—Economic Profit (EP)—against which to compare pay. Bloomberg's rationale is that EP is a better focus for management than TSR, and therefore what companies ought to be paying for. In theory, they're right. In practice—especially a practice with significant legal implications—TSR provides a more objective and uniform comparability across companies and time. In contrast, EP must be tailored to each sector (and, often, company), and ought to adapt to changes in one's business model over time.

If the Commission is willing to support an **alignment analysis**, then we would recommend:

1. Defining each year's actual pay as the sum of salary, cash awards, change in the value of equity held during the year, including newly granted equity at its year-end value, change in the present value of benefits, and other compensation.
2. Define "performance" as TSR and, at the discretion of the company, as a profit, return, or other metric that the company believes is a relevant proxy for shareholder value. Do not require that the TSR display be more prominent.
3. Require companies to disclose actual pay and absolute or, at the company's discretion, relative annual performance for each year up to five years, if the company has five years of history as a public company, or for up to three years, if the company is currently required to provide only a three-year history for executive compensation.

Alternatively, if the Commission feels that requiring an annual valuation of equity is too burdensome, or would otherwise wish to limit itself to a **cost analysis**, then we would recommend:

1. Defining "actually paid" based on a reasonable measure of the compensation costs borne by the company for the CEO over his or her full tenure, i.e., from hiring to the date of disclosure, including all cash compensation, plus the value of vesting stock and exercised options, plus the service cost of pensions, plus other compensation, plus potential severance cost based on dismissal without cause or departure for good reason.⁶
2. If a CEO departs during the course of the year, only including the tenure-length pay information for the departing executive, including actual severance costs.
3. Annualizing the tenure-length actual pay.
4. Defining "performance" as TSR and, optionally, peer TSR over the same period as the tenure over which pay is being measured, annualized to be comparable to the actual pay figure.
5. Under this latter, cost-focused view of pay-for-performance, not requiring any additional pay data regarding NEOs.
6. Allowing disclosure of alternative metrics for the company and its peers in addition to TSR, including accounting-based metrics such as net earnings, economic profit, return on capital, etc.

If the Commission decides to **not adopt an alternative method** of calculating actual pay that appropriately addresses alignment, e.g., based on change in management wealth, or cost, e.g., total payouts over the tenure of (only) the CEO, then rather than promote a disclosure that is guaranteed to provide misleading information for most companies, our recommendation would be:

⁶ For the sake of uniformity, simplicity, and reasonableness, we would strongly recommend aligning the SCT definitions of equity compensation and pension cost to be consistent with "actually paid" if the Commission insists on pursuing a "cost" view of pay-for-performance.

Revert to a *principles-based disclosure* that requires a discussion of how the board has attempted to, and in fact achieved, through the design, implementation, and results of its variable compensation plans, an appropriate balance in favor of the investors' interests with regards to cost and alignment.

Conclusion

We do not believe that the market would be well served by a one-size-fits-all pay-for-performance disclosure, especially one, as currently proposed, that will mislead investors in most situations. The market may not yet be ready for a prescribed method of calculating pay-for-performance that would be reasonably free of distortions. We believe that would suggest a principles-based disclosure, instead. If pay-for-performance is to be disclosed according to a rules-based standard, it should be limited to the information needed to enable investors to independently determine relative pay versus relative performance.

What investors need, and all that the law requires, are sufficient data to enable a pay-for-performance analysis that provides meaningful results across a full spectrum of potential pay and performance outcomes. While there are a number of pieces of information that would be useful for investors along these lines, the best way to serve the capital markets would be to have that information provided to investors so that they can individually make pay-for-performance determinations based on their own criteria. That information should ideally be furnished instead of filed in order to encourage bolder disclosure.

More experience with alternative methods of calculating pay-for-performance may eventually yield a consensus on a more uniform, meaningful pay-for-performance disclosure.

I would be pleased to discuss or explain any of these comments, if the Commission wishes, at the contact information provided below.

Sincerely,



Marc Hodak

Hodak Value Advisors

[Redacted contact information]

Appendix

Table 1. Up-front equity award of \$3 million with equal vesting over *four* years

<u>SEC Proposed</u>	Beg. of 2015	2015	2016	2017	2018	2019	Total
Stock price	\$20	\$15	\$12	\$17	\$23	\$30	50%
Value of vesting shares		\$563	\$450	\$638	\$863	\$0	
Actual pay		\$563	\$450	\$638	\$863	\$0	\$2,513
Cumulative TSR		-25.0%	-40.0%	-15.0%	15.0%	50.0%	

<u>SEC Proposed</u>	Beg. of 2015	2015	2016	2017	2018	2019	Total
Stock price	\$20	\$25	\$35	\$45	\$35	\$30	50%
Value of vesting shares		\$938	\$1,313	\$1,688	\$1,313	\$0	
Actual pay		\$938	\$1,313	\$1,688	\$1,313	\$0	\$5,250
Cumulative TSR		25.0%	75.0%	125.0%	75.0%	50.0%	

Table 2. Up-front equity award of \$3 million with equal vesting over *five* years

<u>SEC Proposed</u>	Beg. of 2015	2015	2016	2017	2018	2019	Total
Stock price	\$20	\$15	\$12	\$17	\$23	\$30	50%
Annual value of salary		\$0	\$0	\$0	\$0	\$0	
Value of vesting shares		\$450	\$360	\$510	\$690	\$900	
Actual pay		\$450	\$360	\$510	\$690	\$900	\$2,910
Cumulative TSR		-25.0%	-40.0%	-15.0%	15.0%	50.0%	

1.00 Correlation between actual pay and cum. TSR

<u>SEC Proposed</u>	Beg. of 2015	2015	2016	2017	2018	2019	Total
Stock price	\$20	\$25	\$35	\$45	\$35	\$30	50%
Annual value of salary		\$0	\$0	\$0	\$0	\$0	
Value of vesting shares		\$750	\$1,050	\$1,350	\$1,050	\$900	
Actual pay		\$750	\$1,050	\$1,350	\$1,050	\$900	\$5,100
Cumulative TSR		25.0%	75.0%	125.0%	75.0%	50.0%	

1.00 Correlation between actual pay and cum. TSR

Table 3. Fixed-value stock grants, \$1 million per year, with equal vesting over four years (for simplicity, we do not include a mix of options in this example)

SEC Proposed	Beg. of						Total
	2015	2015	2016	2017	2018	2019	
Stock price	\$20	\$15	\$12	\$17	\$23	\$30	50%
Annual value of salary		\$0	\$0	\$0	\$0	\$0	
Value of vesting shares		\$188	\$350	\$850	\$1,488	\$1,892	
Actual pay		\$188	\$350	\$850	\$1,488	\$1,892	\$4,768
Cumulative TSR		-25.0%	-40.0%	-15.0%	15.0%	50.0%	
Total # of shares granted		13	42	92	156	219	\$6,583 \$30 x #Shares

SEC Proposed	Beg. of						Total
	2015	2015	2016	2017	2018	2019	
Stock price	\$20	\$25	\$35	\$45	\$35	\$30	50%
Annual value of salary		\$0	\$0	\$0	\$0	\$0	
Value of vesting shares		\$313	\$788	\$1,334	\$1,232	\$895	
Actual pay		\$313	\$788	\$1,334	\$1,232	\$895	\$4,561
Cumulative TSR		25.0%	75.0%	125.0%	75.0%	50.0%	
Total # of shares granted		13	35	65	100	130	\$3,890 \$30 x #Shares