

Shareholder Value Advisors

July 6, 2015

Mr. Brent J. Fields
Secretary
Securities & Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

RE: File No. S7-07-15 Proposed Rule on Pay versus Performance (Release No. 34-74835)

Dear Mr. Fields:

I am the President of Shareholder Value Advisors Inc., a consulting firm that helps companies improve shareholder value through better performance measurement, incentive compensation and valuation analysis. I have done extensive research on pay versus performance including work to measure the sensitivity of management pay to changes in shareholder value and to assess the impact of alignment, pay leverage and compensation cost on subsequent company performance. My published research includes “Three Versions of Perfect Pay for Performance” in the *Journal of Applied Corporate Finance* (Winter 2014), “The Three Dimensions of Pay for Performance” in the *WorldatWork Journal* (4th Quarter 2013), “Achieving Pay for Performance” in *Conference Board Director Notes* (December 2012), “Six Factors That Explain Executive Pay (and its Problems)” (with Professor David Young of INSEAD) in the *Journal of Applied Corporate Finance* (Spring 2010), and “What Investors Need to Know About Executive Pay” (with Professor Young) in the *Journal of Investing* (Spring 2010).

Summary of my comments

1. The statutory requirement for pay versus performance disclosure is desirable because (a) there are wide differences in the correlation of total compensation and financial performance across companies and (b) current disclosure regulations have led to very little information about the relationship between *total* compensation and financial performance. For S&P 1500 companies, the variation in five year CEO mark to market (or “realizable”) pay explained by TSR ranges from 10% at the 25th percentile to 86% at the 75th percentile with a median of 58%.
2. The proposed five year reporting period is desirable because it allows more accurate estimates of pay leverage and alignment. With three years of data, the median t-stat for CEO pay leverage is 1.63. With five years of data, the median t-stat is 2.63.
3. The Commission’s interpretation of “compensation actually paid” as including only the vesting date fair value of equity compensation undermines the matching of pay and performance that is a basic requirement of meaningful pay for performance analysis. The value of equity granted prior to the five year performance period will be included if it vests during the performance period and the value of equity granted during the performance period will be excluded if it vests after the performance period. This interpretation will make pay for performance look much worse than it really is. The variation in five year CEO compensation actually paid explained by TSR is only 12% for the median S&P 1500 company. This is no better than the variation in CEO Summary Compensation Table

(SCT) pay explained TSR, also 12%. Since the Commission's interpretation of compensation actually paid incorporates current fair value measurement of vesting equity compensation, many investors may mistakenly believe that the alignment of compensation actually paid and TSR fully captures the alignment created by changes in the value of unvested compensation when, in fact, it barely captures a fifth of that alignment.

4. There is an alternative, and reasonable, interpretation of "compensation actually paid" that does not undermine the matching of pay and performance, i.e., compensation actually paid is all compensation reported in the Summary Compensation Table (with the pension adjustment discussed below) except performance shares that have failed to vest or are likely to fail to vest and stock options that are out of the money (what we'll call "compensation not actually paid"). With this interpretation, the variation in five year CEO compensation actually paid explained by TSR is 19% for the median S&P 1500 company. Since this interpretation values equity compensation at its grant date value, investors should easily understand that alignment of compensation actually paid and TSR – like alignment of SCT pay and TSR – does not fully capture the alignment created by changes in the value of unvested equity compensation.
5. Correlation and sensitivity (or slope) should be the "information" required about the relationship of pay and performance. Companies should be allowed to report correlation and slope using dollars of pay and percentage points of TSR or using log pay and log (1 + TSR). Using dollars of pay, slope is incremental dollars per percentage point of TSR. This slope can't be fairly compared across companies without adjusting for size differences. Using log pay, slope is the percent change in pay associated with a 1% increase in shareholder wealth. This slope can be compared across companies without adjustment. Companies should be required to discuss the reported correlation and sensitivity.
6. Limiting compensation actually paid to grant date equity values, rather than mark to market equity values, is a sensible balancing of cost and benefit. It allows the Commission to limit the burden of compliance until there is more evidence that investors are making extensive use of correlation and slope. The Commission should encourage companies to provide more extensive disclosure, specifically encouraging the use of industry (or peer group) betas to measure relative TSR, reporting correlation and slope with respect to relative TSR, reporting mark to market pay and its correlation and slope with respect to relative TSR, and reporting correlation and slope with respect to operating measures.
7. Compensation not actually paid could be deducted from total compensation in the year of grant or in the year in which it fails to vest, becomes unlikely to vest or falls out of the money. The Commission should require deduction of compensation not actually paid in the year in which it becomes unlikely to vest or goes out of the money because that provides a better matching of pay and performance. Changing to deduction in the year of grant reduces the variation in CEO compensation actually paid explained by TSR from 19% to 15%.
8. Companies should be specifically encouraged to provide scatterplots of pay versus performance rather than time series plots. A scatterplot is the standard statistical analysis for assessing the relationship between two variables. It's well designed to provide visual evidence of correlation and sensitivity. Inferring correlation and sensitivity from a time series plot with multiple scales is challenging even for an experienced statistician.
9. Reporting the service cost of a defined benefit pension or the expected accretion in the benefit value at the start of the year would be a desirable change in the Summary

Compensation Table because it would be more consistent with the reporting of equity compensation at its expected value at the date of grant. The change in pension value over a measurement period is more appropriately a component of mark to market or realizable pay for the period. The expected accretion in the benefit value at the start of the year (which is easier for us to calculate than the service cost) is incorporated in our alternative calculations of compensation actually paid

The potential benefits of the statutory requirement

The statutory requirement for “Disclosure of pay versus performance...including 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 distribution” (Dodd-Frank Act Section 953(a)) has significant potential benefits for investors. The current disclosure requirements have led to very little “information” about the relationship between *total* compensation and financial performance. Very few companies discuss the correlation of total compensation and performance or the sensitivity of total compensation to performance, and very few present a graph showing total compensation and performance. Disclosure is often voluminous, but these critical elements are missing. The 2015 Exxon proxy, for example, has 18 numbered graphs and tables in its CD&A, but only one shows pay and performance in the same graph and that is limited to annual bonus compensation showing percent change in earnings and percent change in bonus in a time series.

While investors can calculate correlation and sensitivity using Summary Compensation Table (SCT) pay and/or estimates of mark to market pay, requiring disclosure of correlation and sensitivity will allow “shareholders to more quickly or easily process the information accurately”. Moreover, the implementation of the statutory requirement will have substantial benefit even for sophisticated investors if it requires companies to discuss the correlation and sensitivity of top management pay.

A better interpretation of “compensation actually paid”

I agree with the Commission that “Congress intended executive compensation ‘actually paid’ to be an amount distinct from the total compensation as reported under Item 402 because it used a term not otherwise referenced in Item 402.” However, the Commission’s interpretation of compensation actually paid as including only the vesting date fair value of equity compensation undermines the statute’s broader objective of disclosing pay versus performance because it creates a significant mis-match between pay period and performance period. The value of equity granted prior to the five year performance period will be included if it vests during the performance period and the value of equity granted during the performance period will be excluded if it vests after the performance period.

An interpretation of compensation actually paid that is more consistent with the objective of matching pay and performance is the exclusion of performance shares awarded during the performance period that have failed to vest or are likely to fail to vest in the future and the exclusion of stock options that are out of the money. This interpretation can be implemented using grant date equity values or mark to market equity values. Implementation using grant date equity values will be much less burdensome for issuers, and I recommend that approach as a conservative balancing of benefit and cost.

The proposed interpretation of “compensation actually paid” will make pay for performance look much worse than it really is

In order to show that the Commission’s interpretation of “compensation actually paid” will make pay for performance look much worse than it really is, we need to (1) explain how to measure pay for performance, (2) show current levels of pay alignment and pay leverage when alignment and leverage are measured over five year periods using all pay granted during the period, and (3) show levels of pay alignment and leverage when alignment and leverage are measured over five year periods just using compensation actually paid, as defined in the proposed rule.

Part 1: how to measure pay for performance

We have developed a pay for performance analysis that uses relative pay and relative performance to calculate the three basic dimensions of pay for performance: pay leverage, pay alignment and the pay premium at peer group average performance. We plot relative pay on the vertical axis against relative performance on the horizontal axis (using log scales for both variables) and calculate the regression trendline. The slope of the trendline is pay leverage, or the percent increase in relative pay associated with a 1% increase in relative performance. The correlation of the trendline is pay alignment, or the correlation of relative pay and relative performance. The intercept of the trendline is the pay premium at peer group average performance, a measure of performance adjusted cost.

The analysis is quite general, so pay can be grant date pay or mark to market pay and performance can be TSR, operating return, or another measure of performance. When pay is grant date pay and performance is TSR, relative pay is annual grant date pay divided by market pay for the position, industry and company size, and relative performance is cumulative relative TSR from the start of the measurement period. When pay is mark to market pay and performance is TSR, relative pay is *cumulative* mark to market pay divided by cumulative market pay and relative performance is relative cumulative TSR from the start of the measurement period. When the measurement period is five years – the performance period in the proposed rule – we plot relative *annual* grant date pay for years 1-5 against relative *cumulative* TSR for years 1-5 and we plot relative *cumulative* mark to market pay for years 1-5 against relative *cumulative* TSR for years 1-5.

We calculate relative TSR with an adjustment for the company’s industry (or peer group) beta, i.e., relative TSR = $[(1 + \text{TSR}) / ((1 + \text{industry TSR})^{\text{industry beta}})] - 1$. Industry beta is the slope of the regression trendline relating $\ln(1 + \text{TSR})$ to $\ln(1 + \text{industry TSR})$. When GICS industry groups are used as peers, about 15% of S&P 1500 companies have zero or negative industry betas (and we treat the negative industry betas as zero). For these companies, relative TSR is really gross TSR.

We use *cumulative* mark to market pay because the goal of pay for performance is to provide perfect alignment of cumulative pay and cumulative performance. In our work on perfect pay plans, we’ve shown that a simple pay plan with annual grants of performance shares can provide perfect pay for performance, i.e., a perfect correlation of relative cumulative pay and relative cumulative performance, a zero pay premium at peer group average performance and pay leverage of 1.0 (or any target leverage). The perfect pay plan differs from

conventional pay practices in three ways. First, target pay is not market pay, but market pay adjusted for trailing relative performance. In other words, there is competitive pay for *average* trailing performance, not competitive pay for *any* trailing performance. Second, the role of vesting is not to leverage operating performance, but to take out the industry component of the stock return. Thus, the vesting multiple is $1/(1 + \text{the industry return from the date of grant})$. Third, non-performance pay is treated as a draw against the ultimate value of the performance shares.

Perfect pay for performance requires that relative annual grant date pay be perfectly correlated with relative cumulative performance but doesn't imply any particular relationship between cumulative grant date pay and cumulative performance. That's why we relate relative *annual* grant date pay to relative *cumulative* performance.

We estimate alignment, leverage and performance adjusted cost for S&P 1500 executives using data from the Execucomp database. Execucomp does not report vesting data, so it's necessary to make assumptions about the vesting periods for restricted stock, the vesting periods, performance measures and performance standards for performance shares and the vesting periods for stock options and the exercise decisions of option holders. We assume four year pro-rata vesting for restricted stock, three year cliff vesting for performance shares and three year cliff vesting for stock options with exercise at the end of the option term. We assume a typical vesting schedule for performance shares, i.e., zero vesting at 25th percentile performance and below, 1x vesting at 50th percentile performance and 2x vesting at 75th percentile performance and above with linear interpolation between the 25th and 50th percentiles and between the 50th and 75th percentiles. We assume that the performance measure is relative TSR measured against the company's GICS industry group. Empirical studies of long-term incentive plan design, such as those by James Reda of Arthur J. Gallagher & Co., show that about half of companies use relative TSR at a vesting measure. While many companies use operating measures for their performance share plans, e.g., earnings growth, ROIC, revenue growth or customer satisfaction, it's reasonable to assume that the measures actually used by a company are believed to be operating proxies for superior relative TSR. Since relative TSR is both widely used and a reasonable proxy for other vesting measures, we believe that using relative TSR to estimate vesting for all companies gives a reasonable approximation to actual vesting practices. Moreover, the use of relative TSR to estimate vesting makes the vesting multiple correlated with relative TSR, and hence, should give estimates of pay leverage and alignment with an upward bias that reduces the likelihood of understating true pay leverage and alignment.

Part 2: pay for performance for S&P 1500 CEOs

For S&P 1500 CEOs with at least five years of CEO tenure, median mark to market pay leverage, using all history years in the Execucomp database, is 0.59. This means that a 1% increase in relative shareholder wealth increases relative mark to market pay by 0.59%. Median pay alignment is 0.50. This means that relative performance explains 25% ($= 0.50 \times 0.50$) of the variation in relative pay over the CEO's tenure. The median pay premium at peer group average performance is 0.08 (the pay premium is greater than zero because market pay is measured using all CEOs, not just CEOs with 5+ years of tenure). When we use five year periods and position data (i.e., data from multiple CEOs if there is a new CEO in the period), we get similar results. Median pay leverage is 0.48 and median pay alignment is 0.54.

We also get similar results for leverage and alignment if we ignore market pay and use annualized mark to market pay as the dependent variable in the pay leverage regression. Median pay leverage is 0.48 and median pay alignment is 0.55. This is an important result because it shows that investors can get meaningful estimates of leverage and alignment from the proposed disclosure even though it does not require reporting of relative pay.

We get higher pay leverage and alignment if we assume that all companies have zero industry betas, i.e., relative TSR is gross TSR. Median pay leverage is 0.62 and median pay alignment is 0.78. Higher pay leverage to gross TSR than relative TSR suggests that pay leverage to the industry component of the stock return is greater than pay leverage to the company specific component. We can confirm this with direct calculation. Industry pay leverage is positive for about 75% of all five year periods, and for the median CEO with positive industry pay leverage, relative TSR pay leverage is only 44% of industry TSR pay leverage. This result provides good reason for the Commission to specifically encourage reporting of correlation and slope with respect to relative TSR.

If the limit the sample to five year periods since the adoption of the new proxy disclosure rules in 2006, we get median pay leverage of 0.58 and median pay alignment of 0.76. We'll use these figures as a benchmark in evaluating alternative interpretations of "compensation actually paid."

Part 3: pay for performance using the proposed rule's interpretation of "compensation actually paid"

To help evaluate the Commission's interpretation of "compensation actually paid", we have estimated a simplified version of compensation actually paid, using our vesting assumptions and the proposed rule's definition, and calculated pay leverage and alignment using annualized cumulative compensation actually paid. Our calculation of compensation actually paid is simplified because it does not include the value at vesting of any equity compensation granted *prior* to the five year measurement period. We used the simplified calculation because it was easier to integrate into our existing computer programs for Execucomp. It is our expectation that the simplified calculation would give higher leverage and alignment than a full calculation incorporating grants made prior to the five year measurement period.

To evaluate the Commission's interpretation of compensation actually paid, we calculated pay alignment using annualized cumulative compensation actually paid and compared that with the alignment calculated using annualized cumulative mark to market pay (which takes account of all equity compensation granted in the five year measurement period, regardless of vesting). We calculated, for each five year period, the variance in pay in explained by TSR, i.e., pay alignment x pay alignment, treating cases of negative pay alignment as having zero variance explained.

Compensation actually paid, using the Commission's interpretation, shows far less pay for performance than annualized cumulative mark to market pay. For the median S&P 1500 CEO, TSR explains only 12% of the variation in compensation actually paid, but 58% (= 0.76 x 0.76) of the variation in mark to market pay. Since the Commission's interpretation of compensation actually paid incorporates fair value adjustments, it may be widely interpreted

as capturing the alignment and leverage created by changes in the value of unvested equity even though it clearly fails to do so.

An alternative interpretation of “compensation actually paid” provides better matching of pay and performance periods

An alternative interpretation of compensation actually paid is SCT pay (adjusted to reflect the expected accretion in pension value rather than the actual change in pension value) excluding performance shares that have failed to vest or are likely to fail to vest and stock options that are out of the money. With this interpretation of compensation actually paid, there are two alternative ways to exclude the compensation not actually paid, i.e., deduct it from SCT compensation in the year of grant or deduct it from SCT compensation in the year it becomes likely to fail to vest, i.e., the year when the projected vesting multiple is zero and remains zero for the remainder of the five year period, or goes out of the money and remains out of the money for the remainder of the five year period. If the projected vesting multiple at the end of the five year measurement period is zero, the first year with a projected vesting multiple of zero and projected vesting multiples of zero in all subsequent years of the measurement period is treated as the “unlikely to vest” year. Similarly, if an option is out of the money at the end of the five year measurement period, the first out of the money year with all subsequent years of the measurement period also out of the money is treated as the “out of the money” year.

For the median S&P 1500 CEO, TSR explains 15% of the variation in SCT compensation actually paid when unvested/out of the money equity compensation is deducted in the year of grant and 19% when unvested/out of the money equity compensation is deducted in the year it becomes unlikely to vest or goes out of the money.

Since our proposed interpretation of compensation actually paid is based on grant date equity values, it is likely to be understood by investors as a limited measure of the pay for performance that does not fully capture the alignment and leverage created by changes in the value of unvested equity.

The proposed rule should require issuers to report correlation and sensitivity

The statutory requirement that issuers disclose “information that shows the relationship between executive compensation actually paid and the financial performance of the issuer” should be interpreted to require issuers to report the correlation of compensation actually paid and TSR and the sensitivity of compensation to TSR, i.e., the slope of the trendline relating compensation to TSR. Correlation and slope are easily computed in Excel and investors understand that correlation provides a simple scale for evaluation, i.e., a correlation of zero indicates no relationship between compensation and TSR while a correlation of 1.0 indicates a perfect relationship between compensation and TSR.

Requiring companies to discuss correlation and sensitivity will lead to more focused and informative disclosure to investors, and hopefully, more issuer focus on the appropriate performance measure for correlation and on compensation strategies that will increase correlation.

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The proposed pension adjustment would be a useful addition to the Summary Compensation Table

For S&P 1500 CEOs with pension values, the correlation between the actual change in pension value for a year and the expected accretion in the pension value at the start of the year (with both variables standardized by total compensation before pension) is only 0.28. For the median CEO with a pension value, changing the pension number included in SCT pay increases the correlation of SCT pay with TSR from 0.27 to 0.33.

In our alternative definitions of compensation actually paid discussed above, we have included the expected accretion in the pension value at the start of the year, not the actual change in pension value.

I appreciate the opportunity to comment and I hope my comments are useful to the Commission in revising the proposed rule.

Sincerely,

A handwritten signature in black ink that reads "Stephen F. O'Byrne". The signature is written in a cursive style with a large, stylized initial 'S'.

Stephen F. O'Byrne
President

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Steve O'Byrne is President and co-founder of Shareholder Value Advisors Inc., a consulting firm that helps companies increase shareholder value through better performance measurement, incentive compensation and valuation analysis. His publications include:

- "Three Versions of Perfect Pay for Performance (Or The Rebirth of Partnership Concepts in Executive Pay)" in the *Journal of Applied Corporate Finance* (Winter 2014)
- "The Three Dimensions of Pay for Performance" in the *WorldatWork Journal* (4th Quarter 2013)
- "How 'Competitive Pay' Undermines Pay for Performance (and What Companies Can Do to Avoid That)" (with Mark Gressle) in the *Journal of Applied Corporate Finance* (Spring 2013)
- "Achieving Pay for Performance" in *Conference Board Director Notes* (December 2012)
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- "Six Factors That Explain Executive Pay (and its Problems)" (with Professor David Young of INSEAD) in the *Journal of Applied Corporate Finance* (Spring 2010)
- "What Investors Need to Know About Executive Pay" (with David Young) in *The Journal of Investing* (Spring, 2010)
- "Why Capital Efficiency Measures Are Rarely Used in Incentive Plans, and How to Change That" (with David Young) in the *Journal of Applied Corporate Finance* (Spring 2009)
- "Why Executive Pay Is Failing" (with David Young) in the *Harvard Business Review* (June 2006)
- "Top Management Incentives and Corporate Performance" (with David Young) in the *Journal of Applied Corporate Finance* (Fall 2005)
- *EVA and Value Based Management* (with David Young), McGraw-Hill (November 2000)
- "Executive Compensation" in the *Handbook of Modern Finance* (1997)

Prior to co-founding Shareholder Value Advisors in 1998, Mr. O'Byrne was head of the compensation consulting practice at Stern Stewart & Co. (1992-1998) and a Principal in the executive compensation consulting practice at Towers Perrin. Prior to joining Towers Perrin in 1979, he worked in the tax department at Price Waterhouse and taught mathematics at Loyola University of Chicago. Mr. O'Byrne holds a B.A. degree in political science from the University of Chicago, an M.S. in Mathematics from Northwestern University and a J.D. from the University of Chicago.