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July 6, 2015

Re: Pay Versus Performance
Release No. 34-74835; File No. S7-07-15

Brent J. Fields
Secretary
U.S. Securities and Exchange Commission
100 F. Street, N.E.
Washington, D.C. 20549-1090

Dear Mr. Fields:

Simpson Thacher & Bartlett LLP appreciates the opportunity to submit this comment letter with respect to the proposed rule (the "Proposed Rule") of the Securities and Exchange Commission (the "Commission") to implement Section 14(i) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), which was added by Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Section 14(i) directs the Commission to adopt a rule requiring issuers to disclose "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."

As counsel to many public companies, we are deeply concerned about the potential unintended consequences of the Proposed Rule's mandate that issuers use total shareholder return ("TSR") as the sole measure of their financial performance for purposes of the tabular pay-versus-performance disclosure. For reasons described in detail below, we recommend that proposed Item 402(v) of Regulation S-K, which codifies the pay-versus-performance disclosure requirement, be amended to provide issuers flexibility in determining the measure of financial performance they will use in their pay-versus-performance table. If the Commission decides nonetheless to require issuers to use TSR to define their performance, it should, at a minimum, permit issuers to voluntarily provide pay-versus-performance disclosure in the prescribed table for a longer period than the five-year "measurement period" proposed and should amend the title of the required table to read "Pay Versus Stock Price."

I. Proposed Item 402(v) Should Allow Issuers the Flexibility to Determine the Financial Performance Measure Most Suited For Their Company

A. The Requirement that Issuers Use TSR As Their Measure of Financial Performance Could Undermine the CD&A and the Role of Compensation Committees

While, as noted in the Proposed Rule, Section 14(i) of the Exchange Act "does not specify how registrant financial performance is to be measured," the Proposed Rule would require registrants to use TSR as the sole measure of their financial performance for purposes of the pay-versus-performance disclosure.[1] This prescriptive approach is an unjustified departure not only from the principles-based approach used for purposes of other compensation-related disclosures required by Item 402 of Regulation S-K, but also from the Commission's own historic recognition of the importance of discussing in compensation disclosures the many elements comprising financial performance.

In connection with the adoption of the Compensation Discussion and Analysis ("CD&A") section in 2006, the Commission had proposed eliminating the then-required Performance Graph, which had been intended to show "the relationship, if any, between compensation and corporate performance, as reflected by stock price."[2] The Commission expressed its belief that "the requirement for the Performance Graph is outdated, particularly since the disclosure in the Compensation Discussion and Analysis regarding the elements of corporate performance that a given company's policies might reach is intended to allow broader discussion than just that of the relationship of compensation to the performance of the company as reflected by stock price."[3] In response to commentators who objected to the elimination of the Performance Graph, the Commission retained the Performance Graph requirement, but only for inclusion in annual reports – not in issuers' filed proxy solicitation materials. The Commission adhered to its "view that the Performance Graph should not be presented as part of executive compensation disclosure," reiterating that the graph could "weaken [the] objective" of encouraging broader discussion in the CD&A of the elements of corporate performance considered by the company than merely "the relationship of

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[1] Pay Versus Performance, Release No. 34-74835; File No. S7-07-15 (Apr. 29, 2015) at 45 (hereinafter "Proposed Rule Release").

[2] Executive Compensation and Related Party Disclosure, Release Nos. 33-8655; 34-53185; File No. S7-03-06 (Jan. 27, 2006) at 21.

[3] *Id.* at 21-22.

executive compensation to the performance of the company as reflected by stock price."[4] This reasoning applies equally to the proposed pay-versus-performance disclosure; requiring issuers to use solely TSR to define their financial performance for purposes of the prescribed pay-versus-performance disclosure table could undermine the goal of the CD&A.

The Proposed Rule similarly risks undermining the thoughtful deliberation process undertaken by compensation committees in determining performance. As implicitly acknowledged by the Commission in its 2006 releases, performance is complex, reflecting much more than merely stock price. Compensation committees, charged with the important task of developing the company's unique compensation philosophy and reviewing and approving compensation plans in accordance with that philosophy, often spend as much time discussing *how* to evaluate performance as they do debating *how much* compensation is appropriate for named executive officers. By focusing exclusively on TSR as the measure of a company's performance, the Proposed Rule suggests that discussion of the "how" is significantly less important than of the "how much." Moreover, the Proposed Rule's exclusive focus on TSR may result in more issuers tying their executive compensation to stock price over a relatively short period in an effort to "enhance" their tabular pay-versus-performance disclosure. Accordingly, the Proposed Rule may have the potentially significant unintended consequence of diminishing the currently robust role of compensation committees.

B. Equating TSR with Financial Performance Could Focus Issuers on Short-Term Performance, to the Detriment of Companies and their Long-Term Shareholders

By mandating the use of TSR to the exclusion of all other measures of performance, the Proposed Rule suggests that performance is synonymous with stock price. This is a considerable step backward after years of encouraging the corporate community to view performance more broadly as singular focus on TSR could have grave consequences. For instance, it could direct the efforts of corporate boards and management toward enhancing short-term performance at the expense of long-term investment in the company and the creation of long-term shareholder value. By linking performance to stock price over the short-term, the Proposed Rule could also discourage the reinvestment of profits into the company or impel management to opt against pursuing a strategy that would position the company well over the long term but would not result in immediate increase in its stock price. While the proposed pay-versus-performance disclosure would include the company's cumulative TSR for as long as five years, even five years can be short-term in the context of the company's overall long-term performance.

[4] Executive Compensation and Related Party Disclosure, Release Nos. 33-8732A; 34-54302A; File No. S7-03-06 (Aug. 29, 2006) at 44.

To prevent the overemphasis on short-termism, issuers should be accorded the flexibility in their pay-versus-performance disclosure – as in their CD&A – to determine the measure of corporate performance most appropriate for them and their individual circumstances. While the Proposed Rule permits registrants "to provide supplemental measures of financial performance so long as any additional disclosure is clearly identified, not misleading and not presented with greater prominence than the required disclosure," such supplemental disclosure would not eliminate the concern.[5] Given the prominence of the mandated pay-versus-performance table, many investors, proxy advisory firms, the media and others will focus primarily on the tabular disclosure, rather than on any additional explanatory information supplied in the subsequent narrative (or, for that matter, the company's comprehensive CD&A). Accordingly, issuers should have the flexibility to determine the measure of performance they will use for purposes of the requisite pay-versus-performance chart.

The Dodd-Frank Act's legislative mandate does not prevent the Commission from adopting a more flexible, principles-based approach. With regard to calculation of financial performance, Section 14(i) only requires that "any change in the value of the shares of stock and dividends of the issuer and any distributions" be "tak[en] into account." TSR is one aspect of performance – perhaps an important one – and thus compensation committees often consider TSR among other factors in determining performance. That being said, TSR deserves to be considered in the context of all the other aspects of performance considered by the compensation committee. The Commission can fulfill its mandate by allowing companies to decide how to define their financial performance but requiring that, for purposes of the pay-versus-performance disclosure, a company's chosen measure of performance take TSR into account, among any other elements of performance it sees fit. Such an approach would strike a more appropriate balance between fulfilling the legislative mandate and, at the same time, recognizing the inherent complexity and individuality of financial performance and not encouraging a focus on the short-term horizon. To the extent the Commission is not inclined to provide issuers with complete flexibility within the confines of its legislative mandate, the Commission should, at a minimum, permit registrants to include in the required table other relevant performance metrics in addition to TSR.

C. <u>The Requirement To Use TSR As The Sole Measure of Each Company's Performance Does Not Achieve Comparability, Nor Is Comparability Attainable</u>

In selecting TSR as the required measure of financial performance for purposes of proposed Item 402(v), the Commission explains that "[r]equiring registrants to use a consistently calculated measure, such as TSR, should increase the comparability of pay-versus-performance disclosure across registrants."[6] Regardless of whether TSR is used,

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[5] Proposed Rule Release at 47.

[6] *Id.* at 46.

however, meaningful comparability across pay-versus-performance disclosures will not be achieved, nor should such elusive comparability be prioritized over company-specific disclosure.

The impossibility of comparable pay-versus-performance disclosure under the Proposed Rule is evident in the fact that the Proposed Rule does not mandate issuers to disclose the executive compensation paid by any other companies. If the Proposed Rule requires issuers disclose the TSRs of their peer group members but not the "executive compensation actually paid" to those peers' executives – which, admittedly, would be impossible or, at best, impracticable – there can be no comparability of the relationship between executive pay and the Commission's definition of financial performance. More importantly, the disclosed relationship between "executive compensation actually paid" and TSR will inevitably lack comparability across companies because publicly traded companies have vastly different compensation philosophies and programs, vesting schedules, valuation assumptions, and performance periods. Accordingly, if adopted, the Proposed Rule will result in issuers adding significant supplemental disclosure following their pay-versus-performance tables to explain why their tabular disclosure is an oversimplification and does not accurately disclose the link between the company's executive pay and its financial performance. In turn, investors who are attentive and/or seek comparability will undoubtedly need to invest time in thoughtful and deliberate examination of the entirety of issuers' disclosures, as well as those of their competitors – not only the numbers in their pay-versus-performance tables – in order to completely understand and properly evaluate the relationship between the executive pay and performance of these issuers and their competitors.

Mandating the use of TSR as the sole measure of financial performance does not – and cannot – transform an inherently non-comparable disclosure into a comparable one. The Proposed Rule lacks comparative value – both because issuers would not be required to disclose other companies' executive pay and because of the wide variation in issuers' compensation programs. A principles-based approach, rather than a prescriptive approach that mandates the sole use of TSR, would allow for more effective disclosure of the link between pay and performance as defined by the individual company, based on its unique facts and circumstances.

II. If the Commission Decides to Retain TSR as the Sole Measure of Financial Performance, It Should Allow Issuers to Include Pay-Versus-Performance Disclosure for More Than Five Years

As noted above, TSR is not the correct metric to use for the pay-versus-performance disclosure, as it does not truly reflect the company's operating performance and could lead to potentially significant unintended consequences. If, however, the Commission determines that it is nonetheless optimal to require the use of TSR for pay-versus-performance purposes, it should permit issuers to voluntarily include in their tabular disclosure the company's TSR for a longer period than five years.

For registrants other than smaller reporting companies, the Proposed Rule would "require registrants to provide the pay-versus-performance disclosure for the five most recently completed fiscal years."[7] In some circumstances, however, five years is too short a period for demonstrating a company's performance over the long term and would yield inaccurate and misleading disclosure regarding the company's performance. This point is best illustrated through a real-life example from an actual public company (the "Company"). During and after the financial crisis of 2008, the Company outperformed its peers; at the end of 2008, the Company did not experience nearly as much of a decline in its share price as many companies in its Compensation Comparison Group, and the Company's share price continued to rise steadily after 2008. As a result, as of December 31, 2014, the Company's five-year TSR of 142% and its six-year TSR of 174% each placed the Company at the 55th percentile among its Compensation Comparison Group, since the TSRs of many of its peers for the same period reflected their recovery from the significant decline they experienced in 2008 – just prior to the start of the six-year period. However, an examination of the Company's TSR over the seven-year period ending December 31, 2014 – going back to just prior to the financial crisis – reveals that the Company's TSR was at the 100th percentile in its Compensation Comparison Group. In this instance, the latter percentile more accurately represents the Company's consistent stock price performance over time and was, in fact, one of many factors considered by the Company's compensation committee when setting compensation for its executive officers.

The above example underscores that requiring issuers to compare their executive compensation to their cumulative TSR over the five-year "measurement period" could, in some circumstances, yield misleading results with regard to their performance over the long term. Given the prominence of the prescribed table in the proposed pay-versus-performance disclosure, this concern is not alleviated by issuers' ability to supplement their tabular disclosure with narrative disclosure. It *can* be properly addressed, however, by specifying that any measurement period the Commission decides to adopt for pay-versus-performance purposes should be a *minimum* period. If the Commission adopts the five-year "measurement period" as proposed, it should allow issuers to provide pay-versus-performance disclosure in the required table for a longer period in order to allow those that have outperformed their peers over the long term to accurately disclose their stock price performance and its relationship to their executive compensation.

III. If the Commission Determines Not to Change the Proposed Measure of Financial Performance, It Should Change the Title of the Required Pay-Versus-Performance Table

If the Commission does not apply a more flexible approach to determining financial performance, it should, at a minimum, change the title of the required tabular disclosure to "Pay Versus Stock Price." As explained in Part I above, TSR is not synonymous with an

[7] *Id.* at 49-50.

be misleading to the investing public to name a table "Pay-Versus-Performance" when it does not convey the relationship between executive compensation and financial performance, but only between executive pay and the company's stock price.

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Thank you for the opportunity to comment on the Commission's proposed rule. We would be pleased to discuss our comments with you or provide any additional information you would find useful. If you have any questions regarding this letter, please do not hesitate to contact Avrohom J. Kess at [redacted] or [redacted], Karen Hsu Kelley at [redacted] or [redacted], or Yafit Cohn at [redacted] or [redacted].

Very truly yours,

Avrohom Kess