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July 6, 2015

RE: Pay Versus Performance Disclosure — Mercer Comments (File Number S7-07-15)

To Whom It May Concern:

Mercer has reviewed the proposed Pay Versus Performance rule (the “Proposed Rule”) and we agree companies should disclose in a clear manner the relationship between executive compensation and company financial performance. However, we believe the rule should give companies more room to align the tabular, as well as narrative, disclosure with their pay strategy. We also have comments on the specifics of the Proposed Rule and requests for clarification.

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Mercer has extensive experience designing and implementing executive and director compensation programs and assisting public companies with their executive compensation disclosures. Our Talent business services also include consulting and expertise in broad-based rewards, HR transformation, talent strategy, communication, and mobility, as well as a full range of best-in-class information and technology solutions.

Summary of Mercer recommendations

We appreciate the importance of transparent proxy disclosure of executive pay and its relationship to company financial performance. However, we recommend the SEC give companies greater flexibility to define the relationship between compensation actually paid and company financial performance consistent with their own pay-for-performance definition and philosophy. Here is a summary of our recommendations:

I. Calculating compensation actually paid

We have two comments and one request for clarification for determining compensation actually paid.

- A. Option valuations.** Calculating the vesting date fair value of options and stock appreciation rights (SARs) in accordance with accounting rules would require companies to perform additional analyses to estimate an expected term assumption that we believe would not enhance investors' understanding of the pay-for-performance relationship.

The final rule should use one of two alternative, easier-to-calculate vesting date valuation methods: either intrinsic value or fair value with the SEC's "simplified method" for estimating an option's expected term (defined in Staff Accounting Bulletin No. 107 as the midpoint of the vesting date and the contractual term).

- B. Pension value.** We support an adjustment to the Summary Compensation Table (SCT) pension value, which is extremely volatile because it includes "non-compensation" amounts, such as the change in the value of benefits earned in prior years due to changes in market interest rates, the executive's age, or other actuarial factors. However, we believe the accounting service cost is an equally misleading measure of actual pay because, in many situations, it includes only a fraction of the value of benefits actually earned, while in some situations, it includes amounts that are never earned.

In lieu of replacing the SCT pension value with the accounting service cost, the final rule should replace the SCT pension amount with the actuarial present value at fiscal year-end of the additional benefit earned during the fiscal year, measured using the same assumptions as the SCT calculations (that is, the SCT pension amount excluding the change in value of benefits earned in prior years).

- C. Equity award vesting date clarification.** Under the Proposed Rule, equity awards would be included in the Pay Versus Performance table as of the vesting date, but vesting date is not defined.

The final rule should clarify when an award should be included in the Pay Versus Performance table under various scenarios, including those described in our detailed comments below, such as when vesting doesn't coincide with the completion of a performance period.

II. Measuring company and peer company performance

We understand why the SEC selected total shareholder return (TSR) as a performance metric in the Proposed Rule. However, we have concerns about the limits of TSR as the *sole* measure in the Pay Versus Performance table, and seek clarification of the measurement period and use of a self-selected peer group.

- A. TSR as sole performance measure.** Making TSR the sole measure of company performance in the proposed Pay Versus Performance table could encourage proxy advisors, investors, and the media to draw potentially simplistic, misleading cross-company comparisons. Also, it could encourage management to take a short-term view to the detriment of long-term performance or use a relative TSR metric in their incentive plans even when not consistent with business objectives.

The final rule should permit at least one additional measure to be shown as prominently as TSR in the Pay Versus Performance table and narrative if it is used by companies in their incentive plans.

- B. Clarification of “cumulative TSR.”** The Proposed Rule’s use of the term “cumulative TSR” has generated confusion. It is not clear whether it is based on values matching (1) the cumulative returns for each year in the table as presented in the performance graph of the company’s most recent annual report (one, two, three, four and five years ending in the most recent fiscal year) or (2) the five-year cumulative value ending in each of the applicable years presented in the table.

The final rule should adopt Alternative 2 for both the company and the peer companies it uses in the Pay Versus Performance table.

III. Covered executives

Requiring separate pay disclosure for the CEO and other named executive officers (NEOs) may require lengthy narratives to explain changes in the executive group and, in the case of CEOs, could result in double (or more) counting.

The final rule should limit disclosure to the CEO and, in lieu of aggregating the pay of multiple CEOs, annualize the recurring pay of the CEO serving at the end of the applicable year.

IV. XBRL tagging

We believe making the pay-versus-performance disclosures the first proxy item to be tagged using XBRL will place an additional burden on companies in their first year complying with the new rule and, as noted above, combined with the use of TSR as the sole performance measure, could encourage proxy advisors, investors, and the media to draw potentially simplistic, misleading cross-company comparisons.

The final rule should specify a later effective date for XBRL tagging for all companies, as currently proposed for Smaller Reporting Companies (SRCs).

V. SRCs

The disclosure requirements for SRCs may impede the facilitation of capital formation and may not provide meaningful pay-for-performance comparisons.

The final rule should exempt SRCs from all pay-versus-performance disclosure requirements.

Detailed explanation of Mercer's recommendations

I. Calculating compensation actually paid

A. Option valuations

Calculating the vesting date fair value of options and SARs in accordance with accounting rules would require companies to perform additional analyses to estimate an expected term assumption that we believe would not enhance investors' understanding of the pay-for-performance relationship.

To determine an expected term assumption *at grant* under FASB ASC Topic 718, companies typically must analyze the historical exercise behavior of their employees over a period of many years. Because these analyses are based on at-the-money options, they allow companies to infer future employee exercise behavior required to value new at-the-money grants.

Estimating an expected exercise date for options at their *vesting date* — when they might be at-, in-, or out-of-the money, and with varying amounts of time remaining in their contractual term — would require analyses not typically performed by companies. And for some companies, this data may not be available. The results would likely be highly speculative and,

unlike option valuations presented in financial statements, would not be subject to auditors' review and acceptance, making them less reliable for investors. In addition to the expected term assumption, other option valuation assumptions, including volatility and interest rates, are likely to have changed since the grant date.

We recommend that the final rule use one of two alternative, easier-to-calculate vesting date valuations: either intrinsic value or fair value with the SEC's "simplified method" for estimating an option's expected term. Each would require less effort for reporting companies and be more transparent, and, like the proposal, would be neutral as to when the awards are exercised.

- **Intrinsic value.** Requiring companies to report the in-the-money value (intrinsic value) on the vesting date, with a footnote stating the exercise price and remaining contractual term, would be a more useful and transparent approach. Investors would be able to compute a fair value using their own proprietary option pricing models if they thought the difference was material.
- **Simplified method.** Alternatively, the proposed requirement for a vesting date fair value calculation could be retained, but the rule could allow — or require — companies to use the SEC's "simplified method" for determining the expected term assumption. Under this method, the expected term is the midpoint of the vesting date and the contractual term, as defined in the SEC's Staff Accounting Bulletin No. 107. The SEC permits companies to use this approach when valuing "plain vanilla" options, for Topic 718 purposes, where companies conclude that their historical option exercise experience doesn't provide a reasonable basis for estimating expected term. In addition, the Financial Accounting Standards Board recently endorsed use of the simplified method by nonpublic entities in its exposure draft, [Proposed Accounting Standards Update—Compensation—Stock Compensation \(Topic 718\): Improvements to Employee Share-Based Payment Accounting](#).

B. Pension value adjustments

The Proposed Rule's move away from the SCT pension value is a step in the right direction. The SCT pension value is problematic because — in addition to the value of benefits earned during the current fiscal year — it also includes the year-over-year change in the value of benefits earned in prior fiscal years. As a result, the SCT pension value is extremely volatile and lacks comparability to the SCT value reported for defined contribution (DC) plans:

- **Volatility due to "non-compensation" factors.** A key criticism of the pension amount included in SCT pay is the substantial year-to-year volatility due solely to changes in

market interest rates and other actuarial factors — not the company's compensation decisions. For example, many companies providing defined benefit (DB) plans to key executives saw significant SCT pay increases in 2015 due to a combination of falling interest rates and updated mortality assumptions based on new pension mortality tables published by the Society of Actuaries in 2014.

- **Lack of comparability with DC values.** For DC plans, SCT pay includes the actual or notional contribution made in the year, but not the investment returns or interest credited during the year on the account balance at prior year-end (except for above-market interest). As a result, the total amount reported for DC plans over time will be smaller than the amount reported for DB plans, even when the two plans produce comparable values at retirement. For example, an executive who works for a company for 15 years and earns a DB benefit worth \$1 million at retirement would have a total of \$1 million reported in the SCT table for all years of service. But if the executive had instead earned a \$1 million benefit in a DC plan crediting interest at 5% per year over the same 15 year period, only about \$725,000 would be reported in the SCT table for all years of service.

While we agree with the SEC's objectives for adjusting the pension value — removing excessive volatility and "non-compensation" elements from SCT pay and enhancing comparability with DC plans — replacing the SCT amount with accounting service cost is not the best way to achieve these objectives. Service cost includes only a fraction (in some cases, none) of the value of benefits actually earned when an executive's pay increases faster than expected or the plan is amended to enhance benefits, and it also includes an allowance for future pay increases that, in some cases, never materialize. In addition, service cost presents its own comparability challenges. For example, service cost may use a different assumed retirement age than SCT values and may take into account the probability of termination, disability, or death before retirement (the values shown in the SCT must assume retirement at the earliest unreduced age and ignore preretirement decrements). For benefits payable from qualified or restoration pension plans, these assumptions — and expected salary increase rates — are typically based on expectations for the participating workforce as a whole and may be inappropriate for top executives.

A better fix — that avoids introducing new problems — is to use the actuarial present value at fiscal year-end of the additional DB benefit the executive earned during the fiscal year, measured using the same assumptions as the SCT calculations. Like the service cost, this measure excludes the change in the present value of benefits earned in prior years caused by changes in interest rates, the executive's age, or other actuarial factors unrelated to the company's compensation decisions. But unlike service cost, this alternative measure tracks the actual pattern of benefit accruals and includes the full value of DB benefit increases

resulting from pay increases (whether expected or unexpected) and plan amendments. By better tracking actual benefit accrual patterns, this alternative would also be more comparable to DC plans.

Like accounting service cost, this alternative measure can be readily calculated from available information. The accrued benefit at the end of the current and prior fiscal years must be known for the SCT calculations; the increase in the accrued benefit during the year is simply the difference. The present value factor needed to determine the actuarial present value of the benefit increase during the year is the same factor used in the SCT calculations. (For a more detailed explanation of the pension valuation ramifications and Mercer's recommended alternative, see *GRIST InDepth: SEC's pay-for-performance proposal swaps one flawed pension value for another*, attached at the end of this letter.)

C. Equity award vesting date clarification

The Proposed Rule provides that equity awards are included in the Pay Versus Performance table as of the vesting date but doesn't define vesting date. In SEC staff meetings with the American Bar Association's Joint Committee on Employee Benefits in 2013 (2013 JCEB meeting) and 2014 (2014 JCEB meeting), the staff provided guidance in Q&A form as to when awards should be included in the Options Exercised and Stock Vested Table. Reporting of the awards in the two tables should be aligned and ask the staff to define "vesting date" in the final rule. For example:

- **Awards with retirement-vesting provisions.** Many companies vest awards on retirement, meaning there is no service requirement once a participant becomes retirement-eligible. Staff guidance from the [2014 JCEB meeting](#) states that the retirement feature should be disregarded for purposes of the Options Exercised and Stock Vested Table if the awards would be forfeited upon a termination for cause, and the award should be reported based on its "normal" vesting schedule with a footnote describing the retirement provision. Once the participant retires, the award should be treated as any other fully-vested award. The final rule could adopt this approach for reporting equity awards in the Pay Versus Performance table.
- **Awards with different vesting and performance period end dates.** When a performance period ends on December 31 but the number of shares earned is not determined until performance is certified the following year, SEC staff guidance from the [2013 JCEB meeting](#) states that the last day of the performance period should be considered the vesting date for purposes of the Options Exercised and Stock Vested Table. We agree with this approach. We note, however, that this question does not

explicitly cover the situation where a participant would forfeit the award if he or she was not employed on the payment date. The staff did address this situation for reporting cash retention awards in the SCT, concluding that the timing difference was administrative (rather than an inducement to ensure employment beyond the end of the year) and should be disregarded. The final rule could adopt this approach for reporting equity awards in the Pay Versus Performance table.

II. Measuring company and peer company performance

A. TSR as sole performance measure

The Dodd-Frank Act states the company financial performance measure should take into account changes in stock value, dividends and distributions, which implies TSR would be the appropriate performance measure. Also, using performance graph TSR would reduce the amount of effort required to comply with the Proposed Rule. However, we believe TSR is already overemphasized in comparing pay and company performance owing in part, for example, to proxy advisor Institutional Shareholder Services (ISS)'s sole reliance on TSR in its primary pay-for-performance alignment analysis. Using TSR as the sole performance measure in the final rule would, in our view, magnify this problem and raise the following additional concerns:

- Many companies use other performance measures in their incentive plans, and executive pay may be sufficiently correlated with those measures, but not with TSR.
- TSR is affected by factors other than company performance, such as general market forces and stock market trends.
- Excessive focus on TSR may encourage companies to take actions that will pay off in the short run to the detriment of longer-term performance.
- Emphasizing company and peer TSR comparisons may pressure more companies to use relative TSR in their incentive plans, which may not be consistent with their business objectives.
- Using TSR as the sole performance measure, combined with its tagging in XBRL, could encourage proxy advisors, investors, and the media to draw potentially simplistic and misleading cross-company comparisons.

The Proposed Rule would permit companies to include additional performance measures in their pay-for-performance *narrative*, but supplemental disclosures must “not [be] presented more prominently than the required disclosure.” However, it is not clear if supplemental measures can be included in the *table*.

To allow companies to best align their disclosures with their pay and performance strategies, the final rule should permit at least one alternative measure to be shown as prominently as TSR in the Pay Versus Performance table and narrative if it is used by the reporting company in its incentive plans.

B. Clarification of “cumulative TSR”

The final rule should clarify the term “cumulative TSR” because the Proposed Rule’s use of this term has generated confusion. Commentators have suggested conflicting interpretations, including that TSR is to be reported for each year (1) with values matching the cumulative returns for each year in the table as reported in the performance graph of the company’s most recent annual report, or (2) with values matching the final value in the performance graph that appeared in each of the applicable years’ annual reports. In Alternative 1, TSR would be presented for one, two, three, four and five years, respectively, all from a common starting point five years before the current year. In Alternative 2, five-year TSR would be shown for each year. An illustration of these alternative interpretations assuming presentation in a calendar year company’s 2020 proxy is shown below:

Alternative TSR approaches: 5 years (cumulative)		
Year	Alternative 1: Starting 12/31/14 (matches performance graph in annual report for 2019)	Alternative 2: Starting 5 years before each pay year shown (matches performance graph in each year)
2019	12/31/14-12/31/19	12/31/14-12/31/19
2018	12/31/14-12/31/18	12/31/13-12/31/18
2017	12/31/14-12/31/17	12/31/12-12/31/17
2016	12/31/14-12/31/16	12/31/11-12/31/16
2015	12/31/14-12/31/15	12/31/10-12/31/15

Because compensation for a given year often reflects performance during the last three to five years, we recommend Alternative 2. We believe it will achieve a better matching of TSR with the performance period reflected in compensation actually paid for the corresponding year. Under this approach, once a company has disclosed its own and its peer companies' TSR for a fiscal year in the Pay Versus Performance table, it would continue to disclose the same value for that fiscal year in later years' tables. In addition, it is common for companies to periodically adjust their benchmarking peer group due to mergers, acquisitions, and bankruptcies, for example. Under Alternative 1, a company that adjusts its benchmarking peer group each year would have to calculate one, two, three, four and five year peer company TSR annually. Under Alternative 2, the company would have to calculate peer group five-year TSR only for the most recent year.

III. Covered executives

The Proposed Rule would require companies to compare their performance to CEO pay (aggregated for multiple CEOs in a covered year) and to the average pay of the other NEOs.

A. Aggregating CEO pay

Aggregating compensation for the full year of all individuals serving as CEO (or acting in a similar capacity) during any part of a fiscal year could result in double counting (or possibly triple counting if there was an interim CEO) and could be quite misleading. In the year the CEO is replaced, very large aggregate values may be reported, which could misrepresent the company's pay practices and hinder comparisons from year to year and to other companies. For example, an outgoing CEO might receive one-time severance payments, while the new CEO might receive "make whole" awards to compensate for any pay forfeited at a prior employer, all of which are aggregated and reported as CEO pay.

We recommend the final rule require annualizing the recurring compensation of the CEO serving at the end of the year. If our recommendation is not adopted, the final rule should include only compensation received as CEO during the year in the CEO pay-versus-performance disclosures, even if compensation received in other capacities is required to be reported in the SCT, e.g., for executives promoted to CEO during the year.

B. Limiting disclosure to CEO pay

Requiring separate pay disclosure for NEOs other than the CEO may require lengthy narratives to explain changes in the executive group that could cloud, rather than illuminate, a company's pay-for-performance relationship. Excluding other NEOs' pay from the table would

provide room for more valuable information on a company's performance, including additional performance measures, discussed above.

The final rule should require pay disclosure only for the CEO.

IV. XBRL tagging

Making the pay-versus-performance disclosures the first proxy item to be tagged using XBRL will place an additional burden on companies when they are initially required to comply with the rule and, combined with using TSR as the sole performance measure, could encourage proxy advisors, investors, and the media to draw potentially simplistic, misleading cross-company comparisons. We recommend phasing in XBRL tagging for all companies, as is currently proposed for SRCs, by delaying tagging until the third filing in which pay-versus-performance disclosures are required.

V. SRCs

The additional disclosure requirements for SRCs may impede the facilitation of capital formation. Given that SRC shares are less liquid than those of larger companies, TSR comparisons may be less meaningful. Also, XBRL tagging may be more of a challenge for SRCs than for larger companies. The final rule should exempt SRCs from all pay-versus-performance disclosures.

Thank you for the opportunity to comment on the Proposed Rule. Let us know if you have any questions or comments.

Regards,



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GRIST InDepth: SEC's pay-for-performance proposal swaps one flawed pension value for another

By Heidi Rackley of Mercer's WRG and Aaron Pedowitz of Mercer's Executive Benefits Group
May 20, 2015

In This Article

[Summary](#) | [Two pay measures in proposed 'pay versus performance' table](#) | [Facts for illustration](#) | [SCT pension amount — the basics](#) | [Accounting service cost — the basics](#) | [Changes in interest and mortality assumptions](#) | [Unexpected pay increases](#) | [Plan amendments enhancing benefits](#) | [Other events](#) | [A better approach](#) | [Side-by-side comparison](#)

Summary

The pension value included in “compensation actually paid” under the SEC’s proposed “pay versus performance” disclosure [rule](#) addresses certain concerns with the pension amount shown in the summary compensation table (SCT) but may be an equally misleading measure of actual pay. This article analyzes the shortcomings of both the SCT pension value and the newly proposed measure — the “service cost” actuarially determined for financial reporting purposes. We suggest an alternative measure with two advantages: It would more appropriately reflect the value of pension benefits earned by executives during the fiscal year and could be readily calculated from available information.

Two pay measures in proposed ‘pay versus performance’ table

A new SEC proposal implementing a Dodd-Frank Act mandate would expand executive pay disclosures by adding a pay-versus-performance table and descriptions of the relationships between a company’s executive pay and total shareholder return (TSR), and between the company’s and a peer group’s TSR. ([GRIST #US20150064](#), May 13, 2015, provides a comprehensive overview of the proposed rule.)

This article focuses on the defined benefit (DB) pension values presented in the new pay-versus-performance table. The table would show CEO pay and the average pay of the other named executive officers (NEOs), measured two ways — the amount reported in the SCT and “compensation actually paid.” Compensation actually paid is the SCT total compensation figure

adjusted for equity and pension compensation. For the pension adjustment, the change in the actuarial present value of all the executive's DB plans reported in the SCT would be replaced by the actuarially determined service cost (as defined in Accounting Standards Codification Topic 715) for the executive's service during the year. The discussion below addresses three issues:

- How to determine both pension measures: the amount reported in the SCT table and the accounting service cost
- Why neither measure is appropriate for determining compensation actually paid during a year
- Why our suggested alternative measure would be more appropriate

The final section presents a side-by-side comparison of the three measures.

Facts for illustration

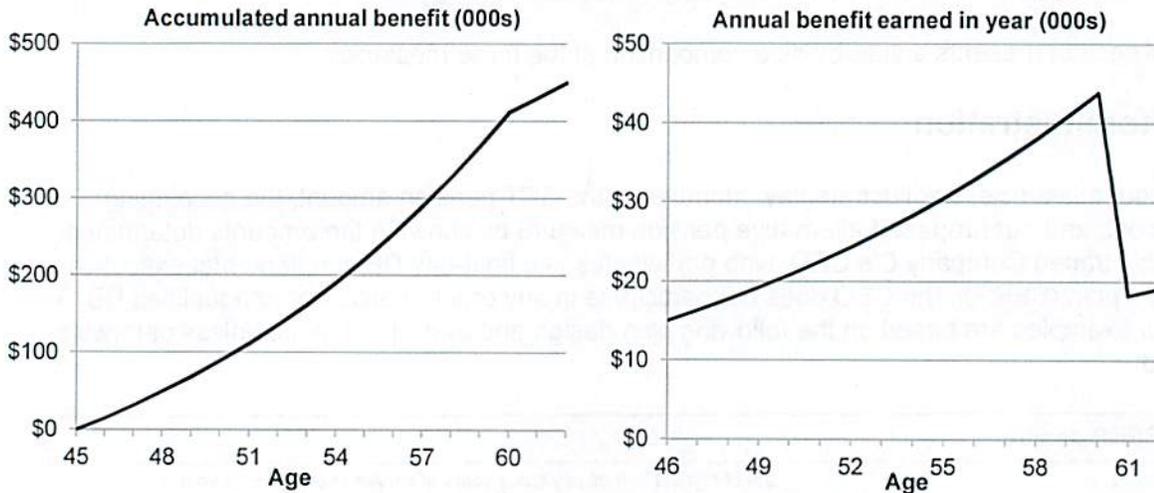
Throughout this article, we illustrate key attributes of the SCT pension amount, the accounting service cost, and our proposed alternative pension measure by showing the amounts determined for publicly traded Company C's CEO, who participates in a final-pay DB supplemental executive retirement plan (SERP). The CEO does not participate in any other qualified or nonqualified DB plans. All examples are based on the following plan design and participant facts, unless otherwise indicated:

Target SERP design	
Benefit formula	3% of highest annual pay times years of service (maximum 15 years)
Normal retirement age	62
Form of payment	Single-life annuity
Time of payment	Payments start the later of age 62 or separation from service
Vesting	Benefits vest at age 55
Participant facts	
Age at hire	45
Age at separation from service	62
Years of service at separation	17 years
Salary in first year of service	\$500,000
Annual salary increase	4.4274%
Pay in last year of service	\$1,000,000

Target SERP design

Annual SERP benefit starting at age 62 $\$450,000 = 3\% \times \$1,000,000 \times 15$ years of service

The charts below and on the next page show the CEO's accumulated annual benefit at each age from hire until retirement at age 62 and the amount of additional annual benefit earned during each year of service. Until age 60, the SERP benefit grows with both service and pay increases. The CEO reaches the 15-year service cap at age 60, and thereafter, the benefit grows only with pay increases.



The calculation details are in the table below:

Age at year-end	Service at year-end	Pay for year	Highest annual pay	Accumulated annual benefit at year-end: $3\% \times \text{Min}(B, 15) \times D$	Annual benefit earned in year: $E - E_{\text{prior year}}$
A	B	C	D	E	F
46	1	\$500,000	\$500,000	\$15,000	\$15,000
47	2	522,137	522,137	31,328	16,328
48	3	545,254	545,254	49,073	17,745
49	4	569,394	569,394	68,327	19,254
50	5	594,604	594,604	89,191	20,864
51	6	620,929	620,929	111,767	22,576
52	7	648,420	648,420	136,168	24,401
53	8	677,128	677,128	162,511	26,343
54	9	707,107	707,107	190,919	28,408
55	10	738,413	738,413	221,524	30,605
56	11	771,105	771,105	254,465	32,941
57	12	805,245	805,245	289,888	35,423
58	13	840,896	840,896	327,950	38,062
59	14	878,126	878,126	368,813	40,863
60	15	917,004	917,004	412,652	43,839
61	16	957,603	957,603	430,921	18,269
62	17	1,000,000	1,000,000	450,000	19,079
Total					\$450,000

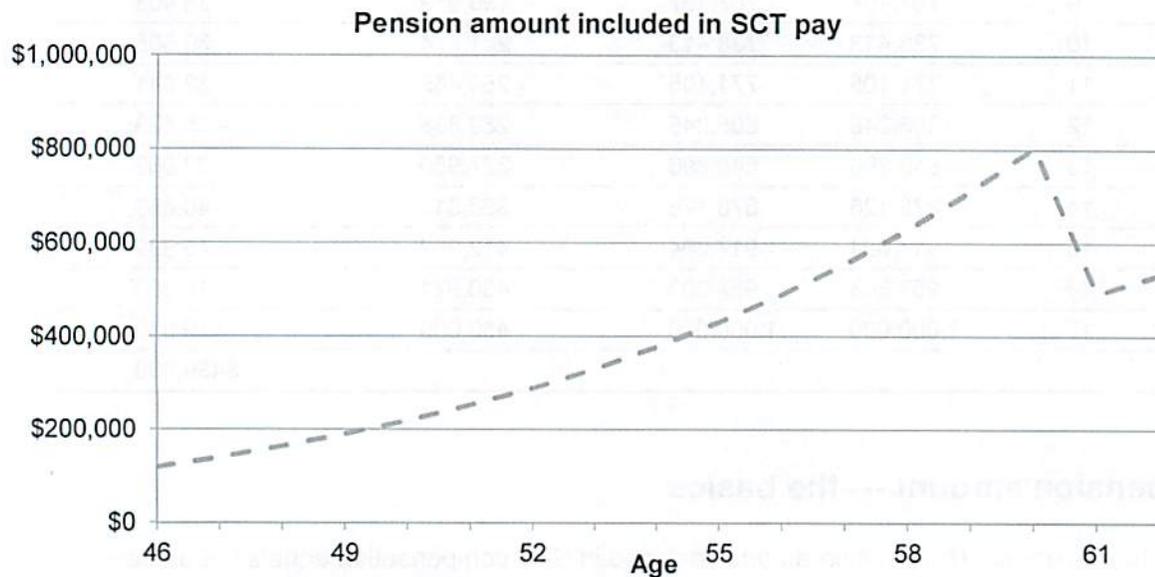
SCT pension amount — the basics

Calculation formula. The pension amount included in SCT compensation equals the actuarial present value of accumulated benefits at the end of the fiscal year, minus the actuarial present value of accumulated benefits at the end of the prior fiscal year. (If the result is negative, as can

happen when interest rates rise or the executive retires later than assumed, \$0 is reported in the SCT and the change in value is shown in a footnote.)

Assumptions. The primary assumptions used in the calculation are retirement age, discount rate, lump sum interest rate (if relevant), post-retirement mortality (if relevant), and payment form. The assumed retirement age must be the earlier of the plan's normal retirement age or the earliest age the executive could receive unreduced benefits. The other assumptions must be the same as those used for financial reporting purposes. "Preretirement decrements" such as turnover, disability, and preretirement mortality must be ignored — even if they are used for financial reporting purposes. As a result, the actuarial present value reported in the SCT does not include the value of any termination, disability, or death benefits associated with those decrements. (See [GRIST #20070177](#), Sept. 19, 2007, and [GRIST #20060210](#), Sept. 1, 2006, for additional information on SCT compensation disclosures.)

Illustration. The chart below shows the pension amount reported in Company C's SCT each year, from the end of the CEO's first year of service through retirement. The values shown assume the discount rate remains constant at 4% and the immediate life annuity factor at age 62 also remains constant at 15.



Page 17

June 23, 2015

GRIST INDEPTH: SEC'S PAY-FOR-PERFORMANCE PROPOSAL SWAPS ONE FLAWED PENSION VALUE FOR ANOTHER

The next table details how the values in this chart are calculated (the calculation of the accumulated benefit at fiscal year-end (column B) is shown in the preceding [table](#)):

Age at fiscal year-end	Accumulated annual benefit at fiscal year-end	Present value factor: $15 / 1.04^{62-A}$	Present value at fiscal year-end: $B \times C$	Amount included in SCT pay: $D - D_{\text{prior year}}$
A	B	C	D	E
46	\$15,000	8.008623	\$120,129	\$120,129
47	31,328	8.328968	260,930	140,801
48	49,073	8.662126	425,077	164,147
49	68,327	9.008611	615,531	190,454
50	89,191	9.368956	835,627	220,096
51	111,767	9.743714	1,089,026	253,399
52	136,168	10.133463	1,379,853	290,827
53	162,511	10.538801	1,712,671	332,818
54	190,919	10.960353	2,092,540	379,869
55	221,524	11.398767	2,525,100	432,560
56	254,465	11.854718	3,016,611	491,511
57	289,888	12.328907	3,574,002	557,391
58	327,950	12.822063	4,204,996	630,994
59	368,813	13.334945	4,918,101	713,105
60	412,652	13.868343	5,722,799	804,698
61	430,921	14.423077	6,215,207	492,408
62	450,000	15.000000	6,750,000	534,793
Total				\$6,750,000

Observations. The pattern looks familiar: The curve's shape is similar to that for the [benefit earned in each year](#), shown on page 3. But the SCT pension amount increases much more steeply from age 46 to age 60. The amount included in SCT pay at age 60 is nearly seven times the amount included at age 46, whereas the benefit earned at age 60 is only three times the benefit earned at age 46. The SCT pension amount also doesn't drop as sharply after the CEO reaches the service cap. Three factors drive this result:

- *Increasing annual accruals.* As is typical for DB plans with final-pay formulas, the additional benefit earned in each year increases steadily until the CEO hits the service cap at age 60. As shown in column F of the [table](#) on page 3, the CEO earns a benefit of \$15,000 in the first year of service, \$16,328 for the second year, growing to \$43,839 in the 15th year.
- *Increasing present value factors.* The value of each \$1 of benefit earned in a year (column C) also increases steadily (by 4% per year) from the CEO's hire date to retirement date.
- *Growth in present value of benefits earned in prior years.* The pension amount included in SCT pay doesn't just reflect the value of the additional benefit earned during the fiscal year — it also includes the growth in value of benefits earned in prior years. For example, of the \$804,698 included in SCT pay at age 60, \$607,974 is the value of the additional benefit earned in that fiscal year, determined as $(\$412,652 - \$368,813) \times 13.868343$. The remaining \$196,724 is the increase in the value of benefits earned in prior years, determined as $\$368,813 \times (13.868343 - 13.334945)$. This component is similar to the interest or investment return credited on the account balance at prior year-end in a defined contribution (DC) plan. Like DC interest credits, this component gets larger as the benefit grows with service and salary increases and as the present value factor increases. But for DC plans, investment return is *not* included in SCT pay (except to the extent a plan credits an above-market interest rate). For this reason, the amount included in SCT pay for a DB plan is *not* comparable to the amount included for a DC plan, even when the value of the total DB benefits earned is similar to the DC account balance.

The amount included in SCT pay dips at age 61 because the CEO has reached the 15-year service cap and the benefit is growing only due to pay increases. But the present value factor and the value of benefits earned in prior years continue to grow by 4% each year, preventing the SCT amount from dropping as much as the benefit accruals.

Accounting service cost — the basics

Calculation formula. The accounting service cost doesn't look at the benefit actually earned at the end of each year. Instead, it starts with the projected benefit expected to be paid at retirement — taking into account expected future service and salary increases — then attributes that benefit ratably to the years of service counted in the plan's benefit formula. The service cost is the actuarial present value of the portion of the projected retirement benefit attributed to the executive's service during the fiscal year. Service cost is determined at the beginning of the year, using assumptions set on the last day of the prior year.

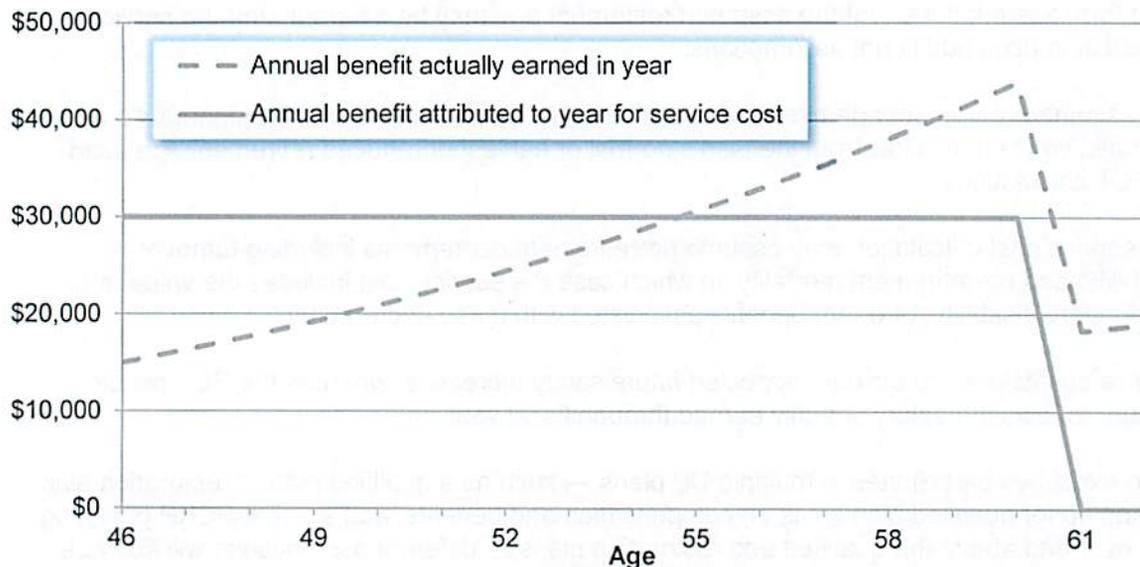
Assumptions. Like the SCT calculations, the accounting service cost uses retirement age, discount rate, lump sum interest rate (if relevant), post-retirement mortality (if relevant), and payment form assumptions. But the assumed retirement age may be different, and the service cost calculation uses additional assumptions:

- The assumed retirement age used to determine service cost is based on management's best estimate, which may differ from the plan's normal or earliest unreduced retirement age used for SCT calculations.
- The service cost calculation may assume preretirement decrements including turnover, disability, and preretirement mortality, in which case the service cost includes the value of any termination, disability, or death benefits associated with those decrements.
- Service cost takes into account expected future salary increases, whereas the SCT pension amount reflects the salary actually earned through fiscal year-end.

When an executive participates in multiple DB plans — such as a qualified plan, a restoration plan that makes up for qualified plan limits on compensation and benefits, and a target SERP providing benefits over and above the qualified and restoration plans — different assumptions will likely be used to determine the service cost under different plans. Service cost for the qualified and restoration plans is typically determined using actuarial assumptions — including preretirement decrements and expected salary increase rates — that reflect expectations for the participant population as a whole, not just the top executive group. In contrast, service cost for target SERPs typically uses assumptions more appropriate to top executives, often ignoring preretirement decrements and using different retirement, post-retirement mortality, and salary increase assumptions than the qualified and restoration plans.

Illustration. Company C expects the CEO to retire at age 62 (the same assumed retirement age used in the SCT calculations), and projects the CEO's highest annual pay will be \$1 million. These assumptions produce a projected retirement benefit of \$450,000 per year starting at assumed retirement age 62 ($3\% \times \$1 \text{ million} \times 15 \text{ years}$). This projected benefit is attributed ratably to the CEO's first 15 years of service because only 15 years are used in the benefit formula. This results in a level \$30,000 benefit ($\$450,000 / 15$) attributed to each of the first 15 years of service, with \$0

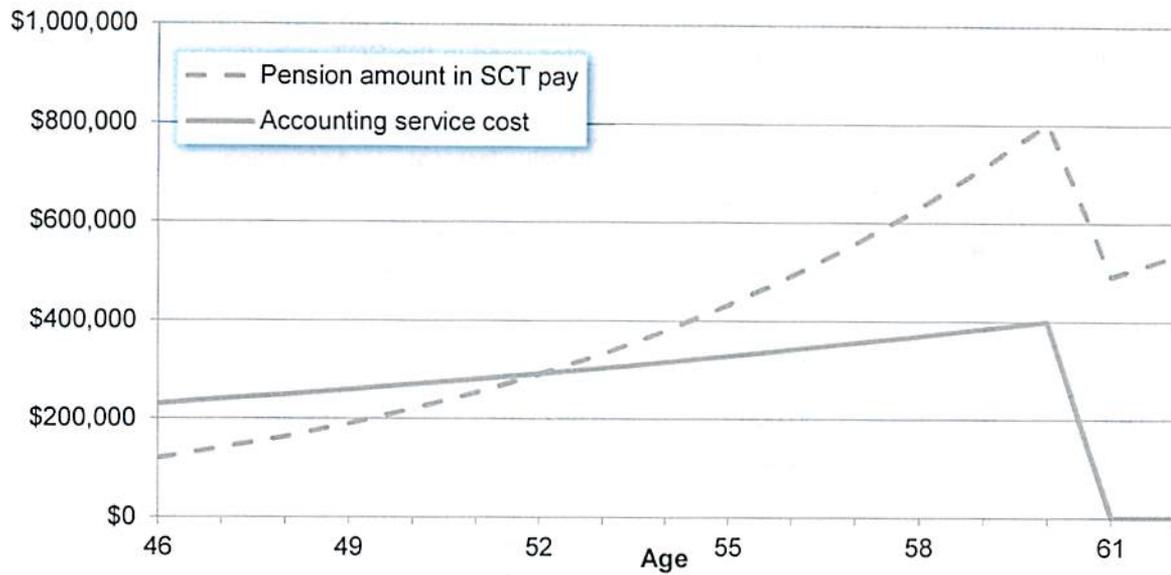
attributed to service after 15 years. The chart below compares the benefit attributed to each year of service under accounting rules with the benefit actually earned in each year by the CEO:



In this example, the same assumptions are used in the service cost and SCT calculations because:

- C's best estimate is that the CEO will retire at age 62 — the same age required to be used in the SCT calculations.
- C decides to ignore preretirement decrements, believing the probability the CEO will terminate, become disabled, or die before the assumed retirement age of 62 is minimal; these decrements must be ignored in the SCT calculations.
- The other assumptions used in the SCT calculations (4% discount rate and age-62 immediate life annuity factor of 15) must match the employer's accounting assumptions.

The next chart shows how the accounting service cost compares with the pension amount included in SCT pay.



The table below shows the service-cost calculation details. Because the service cost is a beginning-of-year number, the present value factor (column D) includes an additional year's discount at the assumed 4% rate compared with the factor used in the SCT [calculations](#), which are as of fiscal year-end.

Age at year-end	Service at year-end	Benefit attributed to service in year	Present value factor at beginning of year: $15 / 1.04^{52 - (\lambda - 1)}$	Accounting service cost: C × D
A	B	C	D	E
46	1	\$30,000	7.700599	\$231,018
47	2	30,000	8.008623	240,259
48	3	30,000	8.328968	249,869
49	4	30,000	8.662126	259,864
50	5	30,000	9.008611	270,258
51	6	30,000	9.368956	281,069
52	7	30,000	9.743714	292,311
53	8	30,000	10.133463	304,004
54	9	30,000	10.538801	316,164
55	10	30,000	10.960353	328,811
56	11	30,000	11.398767	341,963
57	12	30,000	11.854718	355,642
58	13	30,000	12.328907	369,867
59	14	30,000	12.822063	384,662
60	15	30,000	13.334945	400,048
61	16	0	13.868343	0
62	17	0	14.423077	0
Total				\$4,625,809

Observations. Two features jump out when comparing the accounting service cost with the pension amount included in SCT pay:

- The total accounting service cost over the CEO's career (\$4,625,809) is substantially less than the total pension amount included in SCT pay (\$6,750,000). There are two reasons for this:
 - Service cost excludes — while SCT pay includes — the growth in the present value of benefits earned in prior years. This makes service cost more comparable to the amount included in SCT pay for a DC plan, which excludes interest/investment return credited during the fiscal year on the account balance at prior year-end (assuming the DC plan credits no more than market interest). The SEC cited improved comparability to DC plans as one reason for making the switch to accounting service cost in the pay-versus-performance disclosure.
 - Because service cost replaces the actual year-by-year benefit accrual pattern with a level annual accrual of \$30,000 for the first 15 years, substantially more of the benefit is valued using the smaller present value factors at younger ages, and none of the benefit is valued using the highest present value factors at ages 61 and 62.
- The service cost starts higher but increases more slowly and ends much lower than the amount included in SCT pay. Again, this is because service cost replaces the actual year-by-year benefit accrual pattern with a level annual accrual of \$30,000 and excludes the growth in the value of benefits earned in prior years. In the early years, the allowance for future pay increases causes the service cost to be higher than the value of benefits actually accrued. But in later years, the annual benefit actually accrued in a year exceeds \$30,000 (or \$0 after 15 years), and adding in the increase in value of previously accrued benefits drives the pension amount included in SCT pay substantially higher than the service cost. The service cost still grows by 4% per year (the assumed discount rate) for the first 15 years of service. This increase is due solely to the 4% annual increase in the present value factor (column D) applied to the level \$30,000 benefit. Service cost drops to \$0 after 15 years because the plan benefit formula has a 15-year service cap.

As a practical matter, few CEOs or NEOs reported in the SCT and pay-versus-performance tables will be in their early years of SERP benefit service, when service cost exceeds the amount included in the SCT. Most CEOs and NEOs currently participating in DB plans have been in the plans for many years. And few employers (only about a quarter of Fortune 500 companies) have DB pension plans that are open to newly hired executives.

Page 24

June 23, 2015

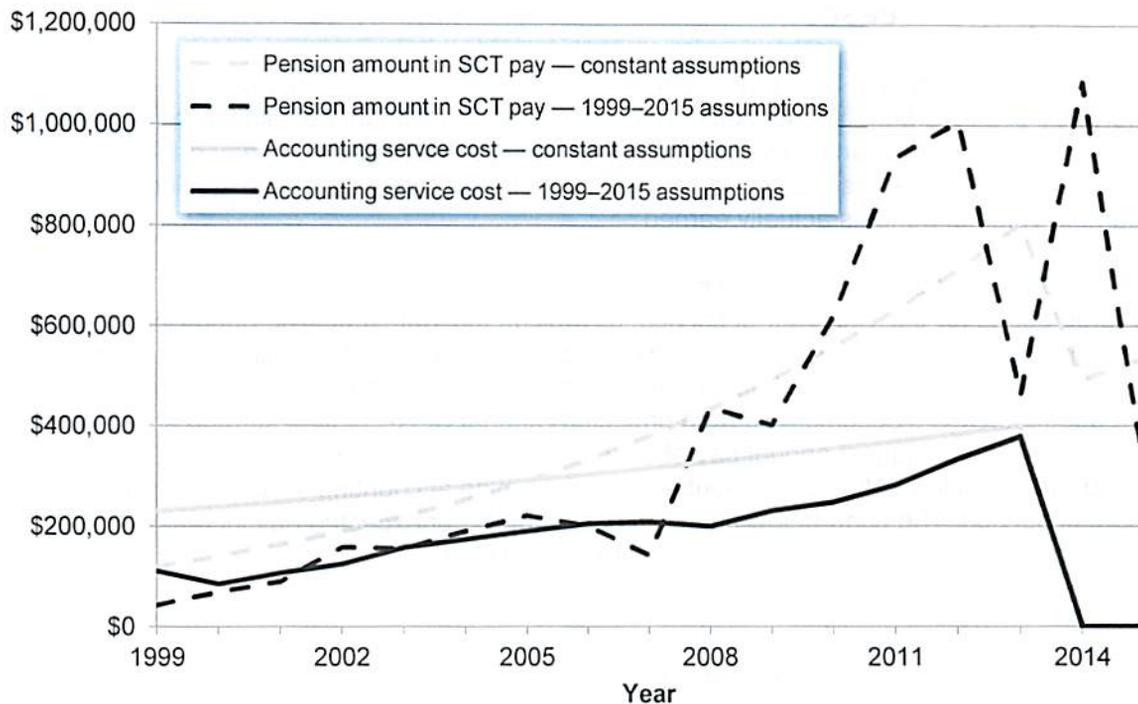
GRIST INDEPTH: SEC'S PAY-FOR-PERFORMANCE PROPOSAL SWAPS ONE FLAWED PENSION
VALUE FOR ANOTHER

Changes in interest and mortality assumptions

In the preceding analysis, both the pension amount included in SCT pay and accounting service cost behaved predictably because discount rates and other assumptions were held constant and experience conformed exactly to those assumptions. Of course, that doesn't happen in the real world. A key criticism of the pension amount included in SCT pay has been substantial year-to-year volatility due solely to changes in market interest rates and other actuarial factors — not the company's compensation decisions. For example, many companies providing DB benefits to key executives saw significant SCT pay increases in 2015 due to a combination of falling interest rates and updated mortality assumptions based on new pension mortality tables published by the Society of Actuaries in 2014 ([Mercer Select](#), Jan. 30, 2015, and [GRIST #20140138](#), Oct. 27, 2014). Dampening this volatility was a key reason cited by SEC for replacing the pension amount in SCT pay with the accounting service cost for the pay-versus-performance disclosure.

To illustrate the effect of real-world interest and mortality changes on the two pension measures, we've turned back the clock and made these assumptions: Company C's CEO was hired Jan. 1, 1999, and will retire Dec. 31, 2015. The SCT and proposed pay-versus-performance disclosures were in effect throughout that period, and C's accounting assumptions were in line with averages for publicly traded companies. Over this period, discount rates were generally declining, from a peak of nearly 8% at Dec. 31, 1999, to a low of about 4% at Dec. 31, 2012, rebounding slightly to an assumed rate of 4.4% at Dec. 31, 2015 (in line with market rates in early May). Mortality assumptions also varied over this period, starting in 1999 with the mortality rates in Rev. Rul. 95-6 (commonly called the GATT-1995 table), moving to the GATT-2003 table in Rev. Rul. 2001-62 for 2002–2007, the Pension Protection Act tables for 2008–2013, and the Society of Actuaries' RP-2014 mortality tables and MP-2014 improvement scale for 2014–2015.

The next chart overlays the pension amount included in SCT pay and accounting service cost determined with 1999–2015 assumptions (black lines) against the corresponding amounts determined earlier in this article using constant interest and mortality assumptions (gray lines). This chart clearly shows the substantial volatility in the SCT amount due solely to interest and mortality changes (the dashed lines). The accounting service cost shows some volatility from interest and mortality changes, but it is much more limited. (Because interest rates were falling throughout the period, the accounting service cost using 1999–2015 assumptions is below the service cost using a constant 4% interest rate. This wouldn't hold true if rates were generally rising.)



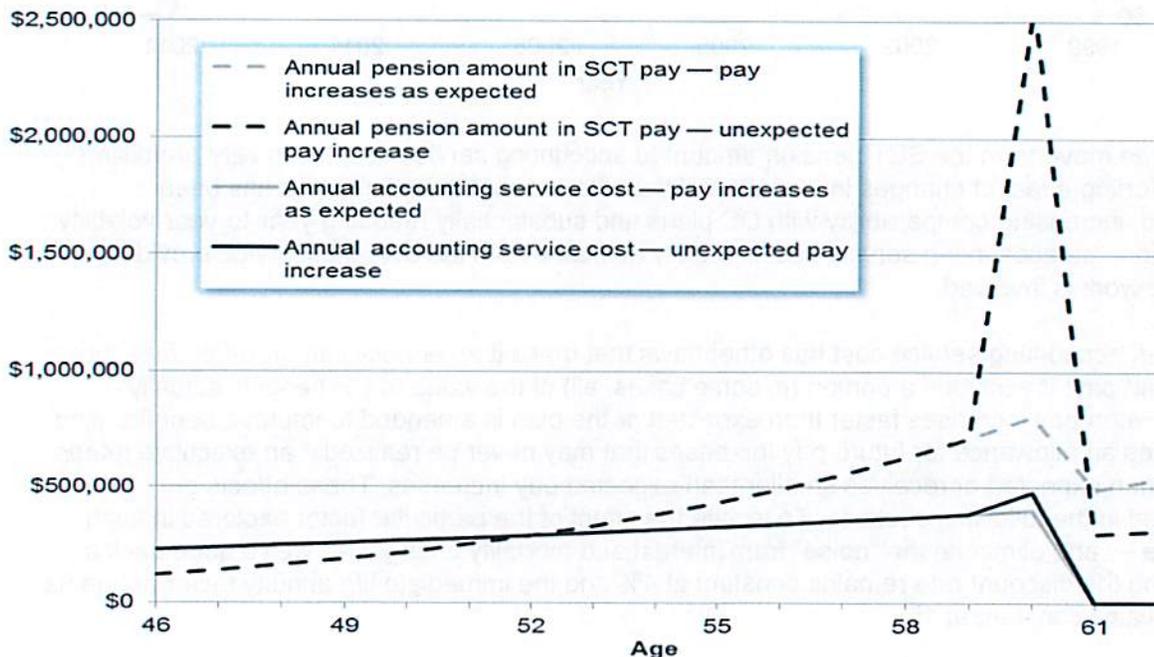
So far, the move from the SCT pension amount to accounting service cost looks very promising. The distorting effect of changes in the value of benefits accrued in earlier years has been removed, increasing comparability with DC plans and substantially reducing year-to-year volatility. In addition, the accounting service cost is readily available from the actuarial service provider, so no extra work is involved.

However, accounting service cost has other flaws that make it an equally inappropriate measure of “actual” pay: It excludes a portion (in some cases, all) of the value of DB benefits actually earned when pay increases faster than expected or the plan is amended to improve benefits. And it includes an allowance for future pay increases that may never be realized if an executive retires earlier than expected or receives smaller than expected pay increases. These effects are illustrated in the following sections. To isolate the effect of the particular factor explored in each example — and eliminate the “noise” from interest and mortality changes — we’ve gone back to assuming the discount rate remains constant at 4% and the immediate life annuity factor at age 62 also remains constant at 15.

Unexpected pay increases

The pension amount included in SCT pay — if totaled over an executive's entire career — will include the value of all DB benefits the executive earns. The same cannot be said for the accounting service cost. Once an executive's pay rises above the level the company originally projected when the executive first began earning DB benefits, the total accounting service cost will be less than the value of benefits actually earned.

This phenomenon is best illustrated by example. Assume Company C's CEO is awarded an unusually large bonus for the 14th year of service, payable in the 15th year. The bonus increases the CEO's highest annual compensation under the DB SERP formula to \$1.2 million. C expects the CEO's compensation will be less than \$1.2 million in the final two years before retirement. The bonus increases the CEO's accumulated (and projected) annual SERP benefit starting at age 62 to \$540,000 (3% × actual highest annual pay of \$1.2 million × 15 years of service) — a 20% increase over the projected \$450,000 amount used to determine accounting service cost for the first 14 years of service. The chart below shows the effect of this unexpected pay increase on the pension amount included in SCT pay and accounting service cost.



Page 27

June 23, 2015

GRIST INDEPTH: SEC'S PAY-FOR-PERFORMANCE PROPOSAL SWAPS ONE FLAWED PENSION VALUE FOR ANOTHER

As would be expected, the pension amount included in SCT pay jumps dramatically in the 15th year. The accrued benefit at year-end is approximately \$127,000 higher than if the CEO's pay growth had matched C's assumptions (\$540,000, compared with \$412,652), increasing the actuarial present value of the benefit at fiscal year-end — and the amount reported in SCT pay — by roughly \$1.8 million.

In contrast, the accounting service cost increases by just \$80,000. Why is the effect on accounting service cost so small? The answer goes back to the attribution method underlying the service cost calculation. To determine the service cost in the 15th year, the \$540,000 projected benefit starting at age 62 (reflecting highest annual pay of \$1.2 million rather than \$1 million) is attributed ratably to the CEO's first 15 years of service. This results in a level \$36,000 benefit ($\$540,000 / 15$) attributed to each of the first 15 years of service, with \$0 attributed to service after 15 years. Had the CEO's pay increased in line with the company's prior expectations, \$30,000 would have been attributed to the 15th year of service. The \$6,000 increase in the benefit attributed to the 15th year increases the service cost by \$80,000.

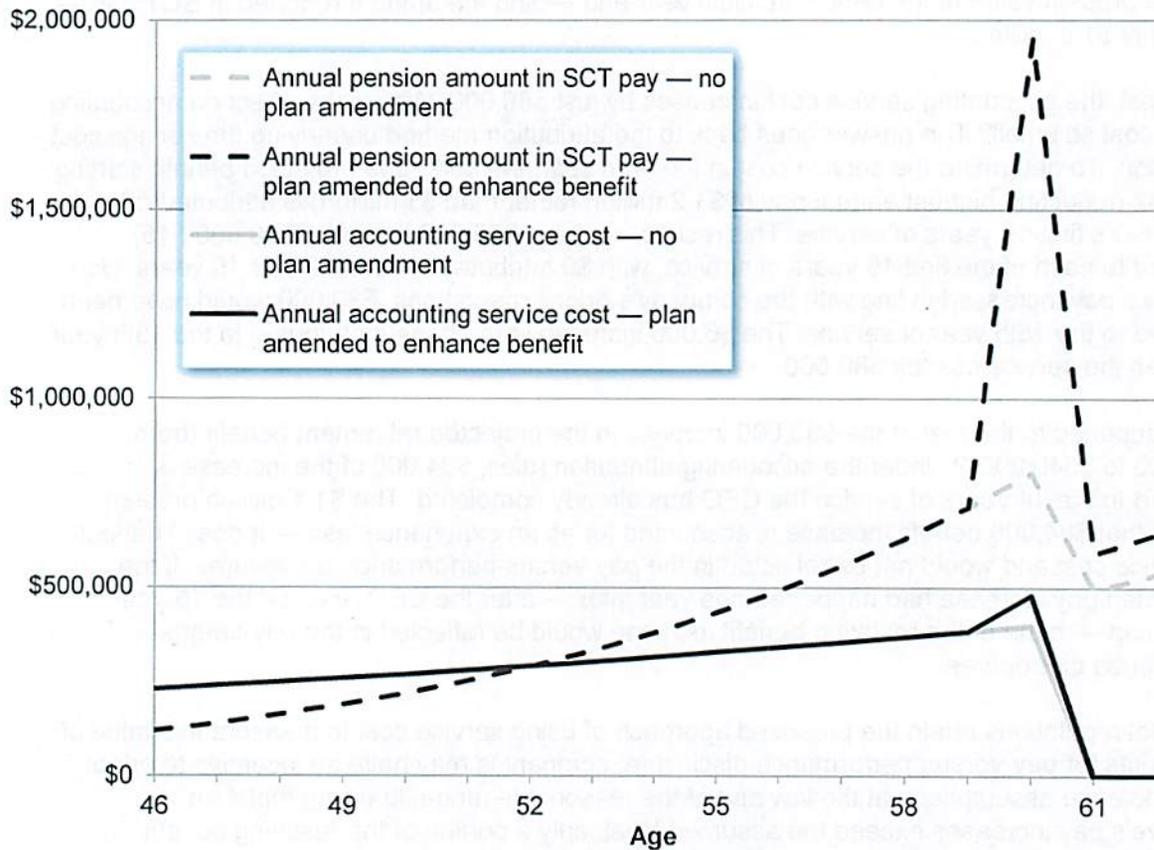
What happened to the rest of the \$90,000 increase in the projected retirement benefit (from \$450,000 to \$540,000)? Under the accounting attribution rules, \$84,000 of the increase is attributed to the 14 years of service the CEO has already completed. The \$1.1 million present value of that \$84,000 benefit increase is accounted for as an experience loss — it doesn't affect the service cost and would not be reflected in the pay-versus-performance disclosures. If the unexpected pay increase had happened one year later — after the CEO reached the 15-year service cap — none of the resulting benefit increase would be reflected in the pay-versus-performance disclosures.

If the final regulations retain the proposed approach of using service cost to measure the value of DB benefits for pay-versus-performance disclosure, companies may have an incentive to adopt salary increase assumptions at the low end of the reasonable range, knowing that if an executive's pay increases exceed the assumed level, only a portion of the resulting benefit increase will ever be reflected in pay-versus-performance disclosures.

Plan amendments enhancing benefits

The effect of a plan amendment enhancing benefits is similar to that of an unexpected pay increase. To illustrate, assume the CEO's pay increases as expected, reaching \$1 million in the last year before retirement. But the company amends the SERP at the start of the CEO's 15th year of service to increase the benefit from 3% to 3.6% of highest annual pay times service up to

15 years. The chart below shows how the plan amendment affects the two measures of pension value.



Similar to an unexpected pay increase, the pension amount reported in the SCT captures the increase in benefits for past and current service in the year the plan amendment is adopted. (The dollar amount reported at age 60 is lower — and the amounts at ages 61 and 62 are higher — than in the salary increase example because the accrued benefit at age 60 is \$495,000, not \$540,000. The CEO earns an additional \$45,000 benefit from pay increases at ages 61 and 62.)

Also, like the unexpected pay increase, the projected benefit payable at age 62 used to determine service cost increases from \$450,000 to \$540,000 ($3.6\% \times \$1,000,000$ highest annual pay $\times 15$

years of service), the benefit attributed to each of the first 15 years of service increases from \$30,000 to \$36,000, and the service cost for the CEO's 15th year of service increases from \$380,000 to \$456,000. This time, the \$1.1 million value of the \$84,000 benefit increase attributed to the CEO's first 14 years of service is accounted for as prior service cost (rather than an experience loss), but it still doesn't change the service cost and wouldn't be reflected in the proposed pay-versus-performance disclosure.

If the final regulations retain service cost as the measure of DB benefits, companies may have incentives to enhance DB benefits late in an executive's career, knowing most of the benefit increase will be attributed to prior years and won't show up in the pay-versus-performance disclosure.

Other events

The preceding sections highlight just two of the many situations that could cause the accounting service cost to be significantly different from the value of pension benefits actually earned by the CEO or other NEOs for service during a year. In practice, service cost will be an inappropriate measure of compensation actually paid whenever an event occurs that gives rise to an experience gain or loss, prior service cost, or curtailment/settlement accounting. Other examples of such events include the following:

- The executive retires earlier or later than the assumed age used in the service cost calculation.
- An executive has higher or lower salary increases than originally anticipated in the service cost calculation.
- The DB plan is amended to freeze benefits.
- A change in control triggers immediate payout of the benefit.

A better approach

As the preceding analysis shows, the pension value included in SCT pay and the accounting service cost both have major shortcomings as measures of compensation actually paid in the form of DB benefits. The pension amount included in SCT pay overstates the compensation value of DB benefits, exhibits significant year-to-year volatility, and lacks comparability with DC plans because it includes the change in the value of benefits earned in earlier years due to changes in

interest rates, the executive's age, or other actuarial factors. Replacing the SCT pension amount with accounting service cost addresses these problems, but introduces new ones that make service cost an equally misleading measure of actual pay. Service cost includes an allowance for future pay increases that may never materialize, but excludes a portion (in some cases, all) of the value of benefits actually earned when pay increases faster than expected or the plan is amended to enhance benefits.

A more appropriate pension measure would be the actuarial present value at fiscal year-end of the additional DB benefit the executive earned during the fiscal year, measured using the same assumptions as the SCT calculations. Like the service cost, this measure would exclude the change in the present value of benefits earned in prior years caused by changes in interest rates, the executive's age, or other actuarial factors unrelated to the company's compensation decisions. But unlike service cost, this alternative measure tracks the actual pattern of benefit accruals and includes the full value of DB benefit increases resulting from pay increases (whether expected or unexpected) and plan amendments. By better tracking actual benefit accrual patterns, this alternative would also be more comparable to DC plans.

What's more, this alternative measure can be readily calculated from available information. The accrued benefit at the end of the current and prior fiscal years must be known for the SCT calculations; the increase in the accrued benefit during the year is simply the difference. Likewise, the present value factor needed to determine the actuarial present value of the benefit increase during the year will already be known from the SCT calculations. Expressed as a mathematical formula where AB_T is the accumulated benefit at the end of fiscal year T and PV_T is the present value factor at the end of year T:

$$\text{SCT pension amount} = (AB_T \times PV_T) - (AB_{T-1} \times PV_{T-1})$$

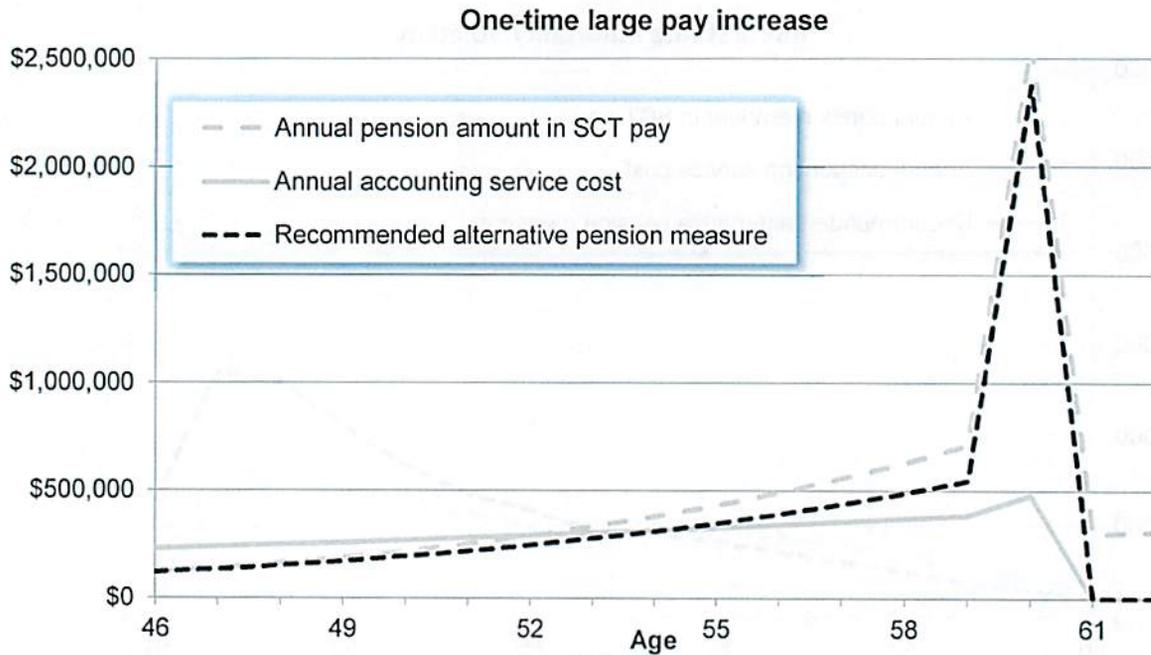
$$\begin{aligned} \text{Recommended alternative measure} &= (AB_T - AB_{T-1}) \times PV_T \\ &= \text{SCT pension amount} - [AB_{T-1} \times (PV_T - PV_{T-1})] \end{aligned}$$

The charts below compare the recommended alternative measure with the pension amount included in SCT pay and the accounting service cost under the three scenarios illustrated above.

Page 31
June 23, 2015
GRIST INDEPTH: SEC'S PAY-FOR-PERFORMANCE PROPOSAL SWAPS ONE FLAWED PENSION
VALUE FOR ANOTHER

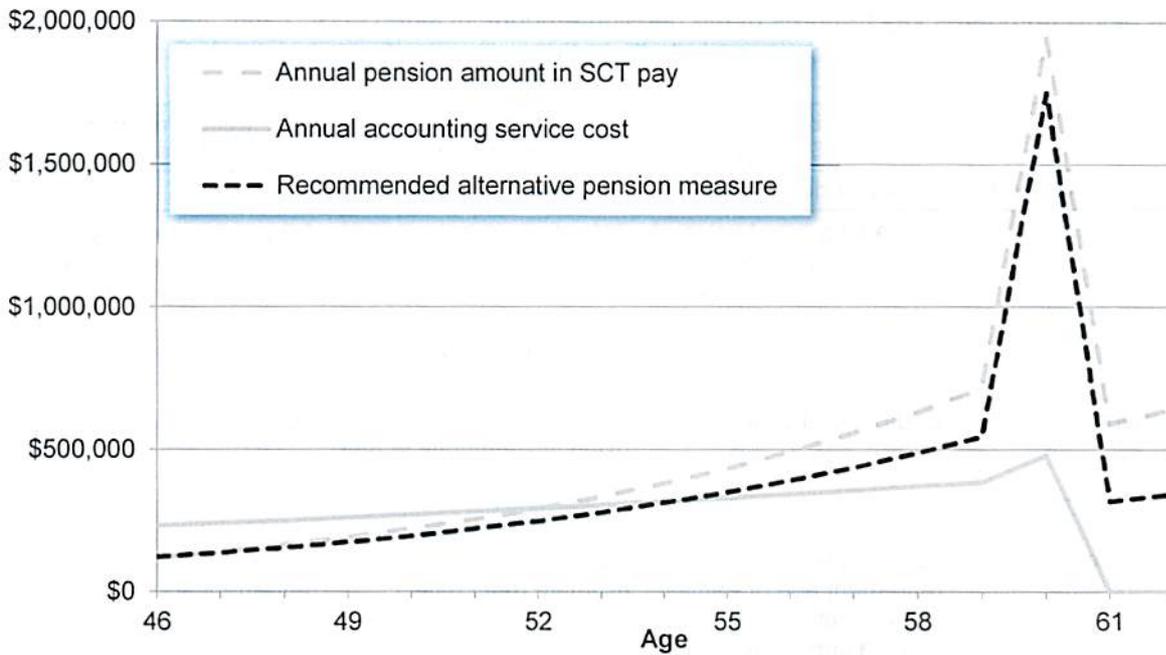


Page 32
June 23, 2015
GRIST INDEPTH: SEC'S PAY-FOR-PERFORMANCE PROPOSAL SWAPS ONE FLAWED PENSION
VALUE FOR ANOTHER



Page 33
June 23, 2015
GRIST INDEPTH: SEC'S PAY-FOR-PERFORMANCE PROPOSAL SWAPS ONE FLAWED PENSION VALUE FOR ANOTHER

Plan amendment enhancing benefits



Side-by-side comparison

The table below compares key features of the pension amount included in SCT pay, the accounting service cost, and our recommended alternative measure of pension value.

Feature	Pension amount in SCT pay	Accounting service cost	Recommended alternative
Calculation formula and measurement date			
Calculation formula	Actuarial present value of accumulated benefits at fiscal year-end minus corresponding value at prior year-end	Actuarial present value of portion of projected retirement benefit attributed to current fiscal year under accounting rules	Actuarial present value of increase in accumulated benefit during the fiscal year
Measurement date	End of fiscal year	Beginning of fiscal year, using assumptions at end of prior year	End of fiscal year
Assumptions			
Assumed retirement age	Earlier of normal retirement age or earliest age executive may receive unreduced benefits	Management's best estimate (may reflect individual facts and circumstances)	Earlier of normal retirement age or earliest age executive may receive unreduced benefits
Discount rate	Effective settlement rate, generally determined by reference to high-quality corporate bond yields	Effective settlement rate, generally determined by reference to high-quality corporate bond yields	Effective settlement rate, generally determined by reference to high-quality corporate bond yields
Lump sum interest rate (if applicable), post-retirement mortality (if applicable), and payment form	Management's best estimates*	Management's best estimates*	Management's best estimates*
Preretirement decrements	Ignored	Management's best estimates*	Ignored
Future salary increases	Ignored	Management's best estimates*	Ignored

Feature	Pension amount in SCT pay	Accounting service cost	Recommended alternative
Benefit values included/excluded			
Change in value of benefits earned in prior years	Included	Excluded (benefits "attributed" to prior years under accounting rules will generally differ from benefits actually earned in prior years)	Excluded
Value of benefits expected to be earned if salary increases as expected	Excluded	Included	Excluded
Value of benefits actually earned from unexpected pay increases	Included	Excluded to the extent attributed to service in prior years under accounting rules	Included
Value of enhanced past-service benefits provided by plan amendment	Included in fiscal year amendment is adopted	Excluded as prior service cost	Included in fiscal year amendment is adopted

* For qualified and restoration plans, management's best estimate assumptions are generally based on expectations for the participant population as a whole and may not be appropriate for the CEO and other NEOs.

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