July 10, 2015

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

Re: File Number S7-07-15 Concerning Pay Versus Performance
(Under Section 953(a) of the Dodd–Frank Wall Street Reform and Consumer Protection Act)

Dear Mr. Fields, Chair White, and Commissioners:

Thank you for the opportunity to comment on the newly proposed rule on pay versus performance under Section 953(a) of Dodd–Frank. This comment is offered from the perspective of corporate board members who will be charged with overseeing compliance with the new rule.

The National Association of Corporate Directors is the nation's oldest and largest organization for directors and boards—now more than 16,000 members strong. We convene, educate, and inform directors on a wide range of governance issues, including compensation. Indeed, the board's role in hiring, overseeing, and compensating executives has been central to our mission since NACD's founding. Over the years, NACD has issued many points of guidance for compensation committees. Our contributions include Blue Ribbon Commission reports focused on a variety of topics, including executive compensation, performance metrics, and, most recently, the link between short-term results and long-term value. We have also issued recommendations for preparing the CD&A, principles on pay-for-performance, and commentary from our Fortune 500 Compensation Committee Chair Advisory Council. Executive compensation is also a core component of NACD's two flagship director education programs for new and experienced directors, as well as a standing feature of our webinar programming.

To recap, the pay-versus-performance provision in Section 953 requires a company to provide

> a clear description of any compensation required to be disclosed by the issuer under section 229.402 of title 17, Code of Federal Regulations (or any successor thereto), 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 distributions (p. 4).[1]

In a November 2013 white paper titled *NACD Perspectives: Pay for Performance and Supplemental Pay Definitions*, which we sent to the Commission prior to rulemaking, NACD identified four general principles that we believe should underpin disclosures of the relationship between executive pay and company performance:

- **Standard definitions** (as a baseline, with flexibility of application) of *compensation actually paid* and of *performance*
- **Consistent time horizons**, oriented to the long term
- **Disclosure beyond the CEO** to other named executive officers
- **Recognition of the importance of board judgment** and company context

The present comment letter expands on these four principles in relation to the latest proposed rule.

Standard Definitions

NACD holds the following views on the proposed SEC definitions of key terms:

> ***Executive*** is defined as the principal executive officer (reported as a single number) and the named executive officers (reported as an average).

We agree that disclosure should go beyond the CEO to NEOs; however, we caution that hires and departures will affect this number. In addition, outliers resulting from signing bonuses, change-of-control agreements, or other unusual circumstances may distort results.[2]

> ***Compensation actually paid*** is defined as total pay reported in the summary compensation table in the proxy statement, modified to exclude changes in the actuarial present value of benefits under defined benefit and actuarial pension plans that are not attributable to the applicable year of service, and to include the value of equity awards at vesting rather than their value when granted.

NACD supports the idea that value associated with actuarial assumptions related to pensions should be excluded. On the other hand, we question the Commission's proposal that "equity awards be considered actually paid on the date of vesting and valued at fair value on that date, rather than fair value on the date of grant as required in the Summary Compensation Table" (p. 37). First, executives do not always exercise options on the day they vest; they may wait for years; thus the pay included is not "actually received," per the language of Dodd–Frank. Second, the time that options vest is often far removed from the performance period being measured; it is thus unsuitable as a means for comparing pay and performance. Finally, the Commission's approach does not account for the possibility that the pay may have to be

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[1] We note that it is not entirely clear from the law whether this "change in the value of the shares of stock and dividends of the issuer" should be reckoned as part of compensation actually paid, as part of the financial performance of the issuer, or as part of both calculations.

[2] See Pearl Meyer & Partners, *Client Alert: SEC Proposes New Pay-for-Performance Disclosure Rules* (May 5, 2015).

forfeited due to an accounting restatement or similar event—a very real possibility for some companies, given the pending clawback rule under Dodd–Frank now open for comment.

> ***Performance*** is defined as total shareholder return (TSR) over each of the company's five most recently completed fiscal years. There is also a requirement to compare this total to the TSR over the same period of a peer group chosen by the company.[3]

In NACD's view, the SEC must provide a framework that accommodates all industries and company sizes to meet the intent of the regulation without adverse consequences. TSR can be a valuable data point, but so can ROIC and other measures. As we stated in our 2013 *Perspectives* paper, "while the baseline definition of 'performance' should include total shareholder return (TSR), an isolated emphasis on TSR can result in excessive focus on quarterly financial numbers and encourage short-term thinking" (p. 3). Furthermore, the TSR measure is subject to manipulation by one-off capital actions, such as one-time dividends, share repurchase announcements, spin-offs, and significant increases in debt. Thus it is possible that the SEC's proposal, while well-intentioned, may have some unintended negative consequences for companies and their long-term shareholders.

In the interest of avoiding over-reliance on any single metric, companies may choose to include other financial and non-financial performance measures that they believe to be relevant. Such criteria include not only TSR but also other financial measures (including so-called accounting measures) and nonfinancial measures (such as those related to customer satisfaction, environmental sustainability, talent and human capital, and so on). As the rule itself notes, "Some equity awards may also be subject to performance-based vesting conditions, where the performance conditions may be based on the registrants' stock prices, their accounting performance, *one or more nonfinancial measures*, or some combination of these" (p. 75, emphasis added).

The *NACD 2014–2015 Public Company Governance Survey*, which is based on more than 1,000 responses, indicates that less than half of respondents use TSR to define "corporate financial performance" in their pay plans. Asked to select all applicable options from a list of nine different measures, only 47.8% of respondents selected TSR as a measure used by their boards when defining corporate performance. By contrast, 50.3% report using profits (the most frequently employed measure). Other measures, in order of prevalence, include cash flow (28.5%), ratios such as EPS (36.6%), and sales (32.3%). These are the kinds of measures that appear in proxy statements when companies disclose their compensation philosophies and plans. After all, these measures can drive company value. The ability to provide information on a variety of company-specific metrics in addition to the mandated TSR disclosure will help

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[3] Note 85 of the proposed rule cites Item 201(e) of Regulation S-K, which provides that cumulative total shareholder return be calculated by "dividing the (i) sum of (A) the cumulative amount of dividends for the measurement period, assuming dividend reinvestment, and (B) the difference between the registrant's share price at the end and the beginning of the measurement period; by (ii) the share price at the beginning of the measurement period" (p. 45). We note that the requirements for smaller reporting companies are for each of the three past years, with no mandated peer performance disclosure.

companies explain to shareholders more precisely how executive compensation correlates with corporate performance.

Consistent Time Horizons Oriented to the Long Term

We believe the relationship of compensation actually paid and financial performance of the company during the corresponding period is an extremely complex issue that cannot be reduced to a simple ratio. First, the time horizons for many elements of performance measurement are not congruent. Furthermore, several studies of stock performance show that share price most clearly relates to expectations of future performance (specifically, investors' view of the company's ability to generate free cash flow[4]), not measures of past performance.

We understand, however, that the use of TSR in a pay-to-performance measure may be mandated per the provisions in the Dodd–Frank legislation. If so, then companies should be required to include not only the annual TSR for each year of a five-year period but also a cumulative TSR for longer-term periods such as three and/or five years. We make this specific recommendation in response to question number 46 in the proposed rule, which asks: "Should the pay-versus-performance disclosure be required to use annual data from the five most recently completed fiscal years, as proposed, or aggregated data for the five most recently completed fiscal years?" We believe that a focus on one-year TSR calculations could reinforce short-termism. Motivating managers to focus on annual results may diminish their commitment to longer-term results.

We therefore recommend that companies be able to extend disclosure to longer periods (if they deem such an extension necessary). Instead of a disclosure of five annual TSRs, there could be a disclosure of seven annual TSRs to show a longer trendline. Alternatively, there could be a disclosure of the TSR for a period longer than one year. The disclosure could indicate the reason for choosing the period(s) and list the key events. For example, in the oil industry, it would be informative to see the pay/performance relationship in the context of changes in oil prices over a full price cycle. The choice as to whether to provide this additional disclosure should rest with individual companies. In addition, we believe that the time periods for compensation actually paid and for performance ought to be coextensive with one another. Otherwise, as noted earlier, the pay-performance relationship for the time period in question may be distorted.

Disclosure Beyond the CEO

The proposed rule mandates disclosure of compensation for senior executives beyond the CEO as an average, and we support this approach, as performance is not determined solely by the CEO. In the previous section of this letter discussing definitions, however, we acknowledged the challenges associated with computing an average for an executive group. Given these challenges, companies must be allowed to make additional disclosures in order to explain anomalies caused by the collective nature of the calculation.[5]

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[4] See Alfred Rappaport and Michael J. Mauboussin, "The Trouble with Earnings and Price/Earnings Multiples" (2001).

[5] See Pearl Meyer & Partners, *Client Alert: SEC Proposes New Pay-for-Performance Disclosure Rules* (May 5, 2015).

Recognition of the Importance of Board Judgment

The final provision of the rule states that "registrants would be permitted 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" (p. 47). We strongly encourage the SEC to retain this provision.

We believe boards should have the right to provide supplementary information as they see fit when communicating with shareholders. As we recently stated in the *Report of the NACD Blue Ribbon Commission on the Compensation Committee: Executive Summary*,

> The compensation committee should be able to exercise discretion in evaluating and rewarding performance, as long as it clearly discloses its rationale. No single formula can adequately take into account the wide variety of factors that might affect performance, including industry or external events. As a matter of fairness, boards should regularly consider whether circumstances call for the use of either positive or negative discretion, always clearly disclosing rationale if employed.[6]

As noted in the proposed rule, the pay-versus-performance disclosure can "provide relevant information to shareholders when voting in an election of directors. By helping to inform a shareholder's assessment of a registrant's executive compensation, the new disclosure may help shareholders to evaluate the directors' oversight of this important area" (p. 8). If shareholders are to effectively evaluate the quality of board decisions on executive compensation in relation to company performance, they will need more than a five-year series of annualized TSR calculations. Thus it is important to permit and indeed encourage disclosures of other performance measures beyond TSR.

Conclusion

In short, we are in general agreement with the rule's stated goals to provide definitions, to align time horizons of pay and performance, to include executives beyond the CEO, and to give some role for director discretion—the four points we made in our 2013 perspectives paper. This said, however, we object to the use of TSR as a sole measure of performance, we warn of possible distortions to executive pay, we advocate for longer time horizons when using TSR, and we urge the SEC to allow boards as much discretion as possible in setting performance goals.

A one-size-fits-all approach to the issue of pay versus performance—though simple and attractive to regulators, politicians, and some commentators—is a truly bad idea. It may also establish a de facto standard for compensation plan design, causing compensation committees to abandon an approach that closely links pay plan design to the company's strategy. Regarding disclosures, we believe it is important for management and boards to have an opportunity to tell their story to shareholders in the manner most pertinent to their business, with appropriate "guardrails" to enable comparability.

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[6] See *Report of the NACD Blue Ribbon Commission on the Compensation Committee: Executive Summary* (Washington, DC: NACD, 2015), p. 5.

In closing, we note that the word *versus* implies a tension and even (in the legal sense) an opposition between pay and performance. Because the proposed rule and the Dodd–Frank Act itself both speak of the "relationship" between these two elements, perhaps a better name for the final rule would be "Pay in Relation to Performance."

We hope that these observations and recommendations will be helpful to you as you move toward a final rule implementing Section 953(a) of Dodd–Frank.

Sincerely,

Ken Daly, CEO

Peter R. Gleason, President

Dr. Reatha Clark King, Chair
NACD