



The Predistribution Initiative
1000 Broadway, Suite 480
Oakland, CA 94607

Vanessa A. Countryman
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

March 4, 2022

RE: File Number S7-07-15
Attention: Reopening of Comment Period for Pay Versus Performance

Dear Secretary Countryman:

The Predistribution Initiative (“PDI”) is grateful for the reopening of the comment period and the opportunity to provide comments to the proposal to implement Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (“Dodd-Frank Act”).

PDI team members have over 90 years of combined experience in finance, economics, and corporate law, with a significant focus on environmental, social, and governance (“ESG”) factors and sustainable investing. Members of our team have developed ESG Management Systems for private equity investment firms, co-founded the Impact Management Project, served on working groups and committees of standard setting bodies such as the Sustainability Accounting Standards Board (“SASB”) Standards Advisory Group, structured deals with ESG considerations, worked at Bear Stearns during the Global Financial Crisis, among other experiences that shape our feedback. Our experiences have led us to the understanding of several critical points regarding relevant financial metrics for this comment period.

Additionally, our colleagues at the [Responsible Asset Allocator Initiative \(“RAAI”\)](#) have provided commentary that we support and which we have signed regarding the use of ESG metrics in pay-for-performance reviews. RAAI similarly supports the commentary in this letter and have added their signature below.

We agree with the stated rationale that total shareholder return (“TSR”) is consistently calculated, objectively determinable, and minimizes both the reporting burden for registrants and the complexities of analysis for investors. We also understand that TSR provides a useful measure of returns based on stock price performance and dividends received.

However, we find that using TSR presents complex challenges. For example, it may not be an effective way to incentivize management performance, it does not adequately address the problem of mitigating “pay-for-luck” performance, and the value accrued to shareholders demonstrated by TSR can be manipulated through financial engineering that may be harmful to companies and their stakeholders, resulting in systematic risk. For investors, presenting TSR as a stand-alone metric in isolation of risk metrics and leverage ratios might be misleading. It might also encourage companies to award performance-based pay misaligned with the long-term financial performance of the firm. To some extent, this might be mitigated (but not completely) by presenting information regarding Peer Group TSR.

Given these shortcomings, we recommend that other metrics be included alongside TSR that may be less vulnerable to financial engineering, for example EV/EBITDA, to provide a more complete picture of corporate performance relative to executive pay.

I. Shortcomings of TSR as a stand-alone metric

1) TSR is ineffective as an incentive metric

In practice, it isn’t clear that using TSR in a long-term incentive program actually improves company performance. [Research](#) conducted by Pearl Meyer and the Cornell University ILR School’s Institute for Compensation Studies found that including TSR in a long-term incentive plan did not improve company financial performance or future TSR.¹ In fact, there was a weak negative relationship between the use of TSR and revenue growth in the year following implementation of a TSR-based incentive plan. Mandating the disclosure of pay-for-performance through the TSR lens could end up reinforcing TSR as a market norm for corporate executive compensation and performance when it is not effective as an incentive metric.

2) Minimizing “pay for luck” requires financial disclosure beyond TSR

A related issue with TSR is that stock prices can often be affected by external factors completely unrelated to managerial skills, such as industry trends and market forces, which can unfairly reward (or penalize) executives. This is the “pay for luck” hypothesis well documented in academic literature.² There is [research](#) finding that “pay for luck” has declined since the introduction of executive pay disclosure reforms by the SEC in 2006, which mandated increased

¹ Hassan Enayati, Kevin Hallock, and Linda Barrington, *TSR, Executive Compensation, and Firm Performance: A Brief Prepared by the Institute for Compensation Studies*, ILR SCHOOL, CORNELL UNIVERSITY (September 24, 2015). Available at https://archive.ilr.cornell.edu/sites/default/files/ICS_TSR_Brief_Oct_15.pdf

² Gerald T. Garvey and Todd T. Milbourn, *Asymmetric benchmarking in compensation: Executives are rewarded for good luck but not penalized for bad*. JOURNAL OF FINANCIAL ECONOMICS, vol. 82, issue 1, 197-225 (2006). Available at <https://www.sciencedirect.com/science/article/abs/pii/S0304405X06000675>

transparency requirements for performance-based executive pay.³ That is, when shareholders are informed about how the board determines executive pay, and about specific executive contract features (such as peer groups, target levels and other performance measures used to determine executive pay level), companies are incentivized to design compensation plans that successfully filter out performance factors beyond executives' control (known as relative performance evaluation).

3) TSR can be manipulated through financial engineering

Executives can be incentivized to manipulate TSR through leverage or opportunistic stock buybacks. Using TSR in the proposed disclosure as a stand-alone metric to test the adequacy of incentive pay and company performance could be misleading to the extent firms rarely disclose the impact of financial engineering on performance metrics such as TSR. This means there may be little scope for shareholders (even informed investors) to evaluate the impact of financial engineering on compensation amounts that executives are receiving, particularly with buybacks.

Recent empirical [research](#) conducted by Nitzan Shilon suggests that the ability to engage in buybacks that affect EPS and TSR can ultimately significantly impact amounts paid to executives as compensation.⁴

Stock buybacks are a double-edge sword for investors. Though they can be beneficial, they can also be detrimental to long-term value creation if executives are motivated to conduct stock buybacks solely in order to improve performance measures that affect their pay. Buybacks increase EPS to the extent share numbers are reduced more than earnings. In turn, a higher EPS tends to push up TSR. Stock buybacks can improve TSR even if they do not create firm value, for instance through artificially inflated stock prices. This might happen when markets are inefficient and buybacks are perceived as signaling to the market that firm value exceeds stock price, thereby increasing demand for the stock; or when buybacks help firms achieve EPS forecasts that would otherwise narrowly be missed. Stock buybacks can destroy firm value, for example by depleting funds available for long-term investments. There is significant literature that explores negative impacts of share buybacks in public companies (see for instance William Lazonick, Mustafa Erdem Sakinç and Matt Hopkins on [why stock buybacks are dangerous for](#)

³ Jung Ho Choi, Brandon Gipper, Shawn Shi, *Executive Pay Transparency and Relative Performance Evaluation: Evidence from the 2006 Pay Disclosure Reforms*. STANFORD UNIVERSITY GRADUATE SCHOOL OF BUSINESS, Research Paper No. 3509307, available at SSRN <https://ssrn.com/abstract=3509307> or <http://dx.doi.org/10.2139/ssrn.3509307>

⁴ Nitzan Shilon, *Pay for Destruction: The Executive Compensation Arrangements That Incentivize Value-Decreasing Stock Buybacks* (August 21, 2020). Available at SSRN: <https://ssrn.com/abstract=3678734> or <http://dx.doi.org/10.2139/ssrn.3678734>. See also *Stock Buyback Ability to Enhance CEO Compensation: Theory, Evidence, and Policy Implications*. 25 Lewis & Clark L. Rev. 303 (2021). We note Shilon's proposal to better align buybacks with long-term firm value creation through a novel "Balance Buyback Protection Rule" (similar to dividend protection) that would exclude net unplanned share reductions for purposes of determining executive compensation.

[the economy](#); or J.W. Mason on [the disconnect between corporate borrowing and investment](#)) including deterring from reinvestment in the company, in the quality of goods and services, and in the workforce.⁵

Stock buybacks are also often funded through the issuance of new debt, and used as a leverage management tool.⁶ Executives can be motivated to conduct buybacks that improve TSR even at the cost of incurring excessive financial leverage. Excessive leverage is a financial stability concern. High leverage increases the likelihood of future financial distress, likely to materialize well after managers have been paid. High leverage ratios may not seem problematic when markets are stable and debt is cheap to service, but they weaken capital structures and make them vulnerable to downturns or interest rate hikes. Periods of market turmoil, such as the recent Covid-19 pandemic, shed light on the effect of high leverage, particularly in terms of its adverse impact on financial stability. In its [May 2020 Financial Stability Report](#), the Federal Reserve found that at the end of 2019, business debt levels were high relative to business assets and GDP, which made the economy even more vulnerable to the outbreak. Combined with the sudden drop in GDP, this eventually pushed the credit-to-GDP ratio to historical highs, as documented in the [May 2021 Financial Stability Report](#). High leverage is not just a concern in terms of risks to individual companies, but it also poses systemic risks to the financial sector and systematic market risks to investor portfolios, the mitigation of which should be of concern to the SEC.

II. Additional financial performance measures beyond TSR

In spite of these reservations we still believe that TSR is a good starting point as an “objective” measure of firm performance, but on its own insufficient to provide clarity to investors to evaluate if executive pay is unjustified. As such, PDI generally supports disclosure of additional financial performance measures beyond TSR.

The proposed rule suggests potential disclosure of other measures of performance, including pre-tax net income and net income. We agree that additional financial performance metrics should be prescriptive to allow for uniform comparisons across registrants and prevent cherry picking (i.e. companies presenting themselves in the best light possible by selecting the most favorable metric). However, for purposes of helping investors assess pay-performance, the SEC may instead consider financial ratios such as EV/EBIT or EV/EBITDA in lieu of pre-tax net income and/or net income. Financial ratios are generally more meaningful than standalone numbers.

A metric like ROE is helpful in that it measures returns for shareholders on the basis of net income relative to equity capital invested in the business. However, ROE can be increased

⁵ William Lazonick, Mustafa Erdem Sakinç, and Matt Hopkins, *Why Stock Buybacks Are Dangerous for the Economy*, HARVARD BUSINESS REVIEW (January 7, 2020). Available at <https://hbr.org/2020/01/why-stock-buybacks-are-dangerous-for-the-economy>

⁶ Sirio Aramonte, *Mind the buybacks, beware of the leverage*, BANK OF INTERNATIONAL SETTLEMENTS Quarterly Review (September 2020). Available at https://www.bis.org/publ/qtrpdf/r_qt2009d.htm

through leverage and financial engineering. Buybacks can improve financial measures of performance including ROE, to the extent it reduces the book value of equity without affecting the numerator in the equation.⁷ For this reason, we suggest that the SEC consider mandating disclosure of ratios which rely on operating income as the core driver of valuation and are unaffected by a company’s capital structure. The SEC should also consider mandating the disclosure of leverage ratios alongside TSR. Though in the current proposed rules such metrics could still be disclosed as part of the “Company-Selected Measure” as a registrant’s most important measure or next-most important measure alongside TSR, for reasons described above disclosure should be prescriptive rather than optional.

Additionally, if the measure deemed most important is already included among the performance measures already being disclosed (which we are suggesting should be EV/EBIT or EV/EBITDA), the company should be required to disclose the next-most important measure not already disclosed as the Company-Selected Measure. The more information shareholders receive about specific executive contract features used to determine executive pay level, the better positioned they are to judge if compensation plans are effectively designed to minimize “pay-for-luck”.

III. Computing the fair value of options at the vesting date as opposed to the grant date

In spite of potential challenges associated with computing the fair value of options at the vesting date as opposed to the grant date, we agree that “actual” pay should be based on the fair value of equity awards as of the date of vesting. In a [report](#) published in 2019, the Economic Policy Institute found that CEO compensation grew more (since 2009) when measured on the basis of the “options-exercised” measure than on the basis of the “options-granted” measure (52.6 percent vs. 29.4 percent).⁸ As such, using the fair value of equity awards on the date they are granted runs the risk of underestimating the actual compensation received by executives. This is problematic for the growing number of investors concerned with executives being overpaid – there is increasing shareholder opposition to executive pay packages, as documented in As You Sow’s recent 2022 [report](#) on The 100 Most Overpaid CEOs, and this is also of particular interest to ESG investors, given that executive compensation has been a significant driver of income inequality.⁹

⁷ We note that not all stock buybacks are conducted for the purposes of altering financial ratios to seem more attractive. For instance, some companies grant stock options to employees to distribute wealth more broadly and then buy back shares to keep the number of shares outstanding constant. It may be argued that buybacks in this situation are value enhancing by supporting employees.

⁸ Lawrence Mishel and Julia Wolfe, *CEO compensation has grown 940% since 1978*, ECONOMIC POLICY INSTITUTE (August 14, 2019). Available at <https://www.epi.org/publication/ceo-compensation-2018/>

⁹ Rosanna Landis Weaver, *The 100 Most Overpaid CEOs*, AS YOU SOW (2022). Available at <https://www.asyousow.org/report-page/the-100-most-overpaid-ceos-2022>

IV. Managing additional sources of systematic risk relating to economic inequality

CEO pay has exploded relative to the pay of average workers. In that same report referenced above, the Economic Policy Institute found that the CEO-to-worker compensation ratio has grown from 20-to-1 in 1965 to 278-to-1 in 2018. Economic inequality is increasingly recognized as a systemic risk to the economy and a systematic risk for markets and investors' portfolios.¹⁰ Given the SEC's mandates to protect investors and maintain fair, orderly, and efficient markets, identifying measures to reduce economic inequality are important for the agency and its constituencies. As such, we also recommend that executive pay-to-average staff pay ratios should be a mandatory metric.

V. ESG metrics

Our colleagues at the Responsible Asset Allocator Initiative ("RAAI") have provided commentary that we support and which we have signed regarding the use of ESG metrics in pay-for-performance reviews. While we recognize that ESG is a concept that continues to evolve and mature, we expect that efforts to measure and manage ESG risks and opportunities will support companies and investors in their long-term goals. It will be important for companies and investors to continuously adapt and improve the identified metrics to ensure they are not "gamed" and do not result in unintended negative consequences.

VI. Promoting a long-term outlook and additional information to consider on best practices relating to pay-for-performance

We encourage the SEC to consider additional factors relating to pay-for-performance, particularly to prioritize metrics that incentivize long-term versus short-term performance. Various academics, industry professionals, and associations have produced guidance on shaping executive compensation to account for long-term versus short-term value creation.¹¹

Additionally, some investors and companies have developed approaches to measure TSR that others can learn from, such as Temasek, which measures its one-year, three-year, and 10-year TSR. As an example, there is a significant difference between annual performance numbers in

¹⁰ As examples, please see: <https://www.washingtonpost.com/business/2019/02/07/federal-reserve-chair-calls-income-inequality-americas-biggest-challenge-next-years/>; <https://www.cnbc.com/2019/04/05/us-income-inequality-is-a-national-emergency-billionaire-ray-dalio-says.html>; <https://fortune.com/2019/11/11/jpmorgan-ceo-dimon-income-inequality-ceo-pay/>; https://www.moodys.com/research/Moodys-Widening-income-inequality-will-weigh-on-US-credit-profile--PR_389062; <https://www.wsj.com/articles/BL-REB-27127>

¹¹ As an example, please see: <https://corpgov.law.harvard.edu/2019/10/03/pay-for-performance-a-mirage/>



2020 compared with 2021, but the difference becomes much less significant when comparing longer-term rolling performance.¹²

To conclude, we appreciate the SEC's attention to this topic and hope that our input is of value.

Kind regards,

Delilah R. Rothenberg
Co-Founder & Executive Director, Predistribution Initiative

Raphaelle Chappe
Co-Founder & Chief Economist, Predistribution Initiative

Scott Kalb
Director, Responsible Asset Allocator Initiative at New America
Chairman, Sovereign Investor Institute at Institutional Investor

¹² <https://www.temasekreview.com.sg/investor/total-shareholder-return.html>;
<https://tr20.temasekreview.com.sg/investor/total-shareholder-return.html#tsr>