

# Shareholder Value Advisors

October 4, 2010

Ms. Elizabeth M. Murphy  
Secretary  
Securities & Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

## **RE: Comments on the pay versus performance disclosure required by Section 953 of the Dodd-Frank Act**

Dear Ms. Murphy:

I am submitting this letter to present my suggestions for implementation of the pay versus performance disclosure required by Section 953 of the Dodd-Frank Act.

I am the President of Shareholder Value Advisors Inc., a consulting firm that helps companies improve shareholder value through better performance measurement, incentive compensation and valuation analysis. Professor David Young of INSEAD and I have done extensive research on pay versus performance including work to measure the sensitivity of management pay to changes in shareholder value and to assess the impact of incentive strength and compensation cost on subsequent company performance. Several of our articles are listed in the brief bio on page 9.

### **"Pay versus performance" disclosure should show the company's success (or failure) in achieving the three basic objectives of management compensation**

Management compensation has three basic objectives:

1. Provide strong performance incentives: give managers sufficient incentive compensation to motivate them to work long hours, take risks and make unpleasant decisions to maximize shareholder value,
2. Retain key talent: give good managers sufficient total compensation to attract and retain them, particularly during periods of poor performance due to market and industry factors, and
3. Limit shareholder cost: limit the cost of management compensation to levels that will maximize the wealth of current shareholders.

Analysis of pay versus performance will be more useful to investors to the extent it shows the company's success (or failure) in achieving these three basic objectives.

A log-log scatterplot of *relative* pay versus *relative* performance with a regression trendline will show (1) a measure of management's performance incentive, (2) a measure of its retention incentive and (3) a measure of cost efficiency. The graph on the following page shows our proposed pay versus performance disclosure for Wal-Mart using data from Standard & Poor's Execucomp database. Page 8 of this letter shows similar graphs for Pfizer and Bank of America. All three graphs incorporate some estimated pay values.

### Proposed "pay versus performance" graph

## 3 Yr Relative Pay vs Relative TSR



The dashed line is the regression trendline relating relative pay to relative performance. The slope of the trendline is the company's "pay leverage," i.e., the ratio of percent change in relative pay to percent change in relative performance. This is a measure of management's incentive to increase shareholder value. Wal-Mart's pay leverage of 0.50 means that a 10% increase in relative shareholder wealth increases relative pay by 5%, on average. If a company's top executives received a fixed number of shares of stock each year (and no other pay), pay leverage would be 1.0 because 10% out-performance would increase pay by 10%. The solid line on the main diagonal shows pay leverage of 1.0.

The solid line on the main diagonal also shows where relative pay is equal to relative performance. If the plot points are predominantly above the solid line, relative pay is above average and the company has a strong retention incentive. Each plot point represents a three year period for one executive. Dates with no suffix, e.g., "99", denote the three year period ending in that year for the CEO. Dates with a "b" or "c" suffix, e.g., "99b" or "03c", denote the three year period ending in that year for the #2 or #3 executive.

The correlation is a measure of how closely the individual points fit the pay leverage trendline. If all the points fall on an upward sloping line, the correlation will be 1.0 and all of the variation in pay will be attributable to performance. If the points are widely scattered around the line, the correlation will be close to zero. The correlation provides a partial measure of cost-efficiency. When it's close to 1.0, pay leverage is provided very efficiently because there is little pay that's unrelated to performance. When it's close to 0, pay leverage is provided very inefficiently. In some unusual cases, e.g., the Bank of America scatterplot on page 8, the correlation is negative and indicates that high relative pay is associated with low relative performance. A negative correlation is meaningful and appropriate in judging pay for performance - it's worse than a zero correlation between pay and performance.

The scatterplot doesn't provide a complete measure of cost-efficiency, but it does give investors the information they need to make their own decision about cost-efficiency. The scatterplot doesn't tell investors whether a company's high pay leverage is sufficient to justify its high relative pay (nor whether a company's low relative pay is sufficient to justify its low pay leverage). That requires a judgment by the investor about the impact of pay leverage on management effort and decision making. But with that judgment and the information from the scatterplot, i.e., the company's pay leverage and its pay premium, an investor can make a decision about the cost-efficiency of the top management compensation program.

### **What the "pay versus performance" graphs for Wal-Mart, Pfizer and Bank of America tell us**

Wal-Mart's pay leverage of 0.50 means that a 10% increase in relative shareholder wealth increases relative pay by 5%. This is approximately 65th percentile pay leverage for the 873 Execucomp companies with 13+ years of history data. Pfizer has much higher pay leverage, 1.21. This means that a 10% increase in relative shareholder wealth increases relative pay by 12%. This is approximately 95th percentile pay leverage. Bank of America has negative pay leverage, -.28. This is approximately 5th percentile pay leverage.

Both Wal-Mart and Pfizer have high correlations between relative pay and relative performance, indicating a high level of efficiency in providing pay leverage. Wal-Mart's correlation of .70 is greater than that of 85% of the Execucomp companies and shows that relative performance has accounted for 49% ( $= .70 \times .70$ ) of the variation in relative pay at Wal-Mart since 1995. Pfizer's correlation of .80 is greater than 95% of the Execucomp companies and shows that relative performance has accounted for 64% of the variation in relative pay at Pfizer since 1995. Bank of America's correlation (-0.26) is lower than 95% of the Execucomp companies and indicates a low level of efficiency in providing pay leverage.

The intercept of the pay leverage trendline tells us the trendline level of pay when the company's return matches the industry. The intercepts (in ln) are +0.44 for Pfizer, -0.45 for Bank of America and +0.02 for Wal-Mart. If we take the anti-log of the intercept and subtract 1, we get the company's percentage premium or discount: +55% for Pfizer, +2% for Wal-Mart and -36% for Bank of America. This gives investors the information they need to make a decision about cost-efficiency. For Pfizer, are the incentive effects from pay leverage of 1.21 sufficient to justify a pay premium of +55%? For Bank of America, are the cost savings from a pay discount of 36% sufficient to offset the weak incentive from pay?

### **The technical details behind the "pay versus performance" graph**

The graph is based on pay for three year periods, valued at the end of the three year period ("mark to market pay"). To limit the impact of promotional pay increases, we exclude an executive in any three year period in which he or she became the CEO. To reduce the impact of pay tied to business unit performance, not corporate performance, we limit the analysis to top 3 executives.

Mark to market pay for a three year period is the sum of:

1. Salary, annual bonus and "other" compensation during the three years,
2. The end of period value of equity compensation granted during the three year period
  - a. Equity compensation includes stock options, performance shares and restricted stock
  - b. The value of a stock option grant is based on the Black-Scholes model using the stock price at the end of the three year period
  - c. The value of a performance share grant is based on the number of shares expected to vest and the stock price at the end of the three year period
3. The end of period value of cash long-term incentive awards made during the three year period, and
4. The change in pension value over the three year period.

Section 953 requires "information that shows the relationship between executive compensation actually paid and the financial performance of the issuer". Mark to market pay is a current estimate of the compensation that will be paid in cash or in "cash equivalent" tradeable securities. Because mark to market pay is a current proxy for future "compensation actually paid", pay leverage and correlation do provide "information that shows the relationship" between compensation actually paid and financial performance. The Commission could require an analysis that only uses compensation paid in cash or "cash equivalent" securities, but that could require very long measurement periods since options might not be exercised for ten years and pensions might not be paid for even longer periods. Long measurement periods would lead to limited data samples and unreliable estimates of the relationship between compensation actually paid and financial performance. I see no benefit to investors in limiting pay versus performance analysis to compensation paid in cash or "cash equivalent" securities.

The vertical axis of the graph is the natural logarithm of relative pay where relative pay is the ratio of the executive's mark to market pay to labor market average mark to market pay for the executive's position or pay rank. Labor market average pay is based on regression trendlines that take account of position/pay rank, industry and company revenue size. The horizontal axis of the graph is the natural logarithm of three year relative shareholder wealth where relative shareholder wealth is the ratio of the company's actual shareholder wealth per share at the end of the three years divided by the share price assuming the industry average return for the three years. We use logarithms to capture the assumption that equal percentage differences in shareholder wealth have a constant percentage impact on pay at each company. This assumption generally fits the data well and provides a simple way to characterize the pay versus performance relationship, i.e., the pay leverage ratio.

The pay leverage trendline is  $\ln(\text{relative pay}) = \text{intercept} + \text{pay leverage} \times \ln(\text{relative performance})$ . When we take the anti-log, we get:

$$\text{relative pay} = \exp(\text{intercept}) \times (\text{relative performance})^{\text{pay leverage}}$$

For Wal-Mart, the equation is  $\text{relative pay} = \exp(.02) \times (\text{relative performance})^{.50} = 1.02 \times (\text{relative performance})^{.50}$ . From this equation, we can see that Wal-Mart pays a 2% premium when the relative performance ratio is 1.0, that is, when actual shareholder

wealth is equal to the share price with the three year industry return. We can also see that a 10% increase in relative performance increases relative pay by roughly 5% since multiplying relative performance by 1.1 increases relative pay by a factor of  $1.1^5 = 1.049$ , or 4.9%.

### **Pay versus performance analysis based on reported annual pay is a second-best alternative**

Three year mark to market pay is a more comprehensive compensation measure than the annual pay ("grant date pay") reported in the proxy because it captures the additional incentive provided by changes in the value of equity compensation after the grant date. And, for the same reason, it provides a more comprehensive pay versus performance analysis. But the use of three year mark to market pay will add to the complexity of the proxy statement disclosure. My personal opinion is that the benefit to investors will justify the additional cost to issuers. However, the Commission may want to consider a less burdensome alternative: require a pay versus performance analysis using three years of grant date pay as reported in the proxy statement and give companies the option to supplement this basic analysis with a pay versus performance analysis based on three year mark to market pay.

The less burdensome analysis will still provide substantial benefit to investors because grant date pay leverage explains more than 50% of the variation in mark to market pay leverage, and hence, would give investors a substantial part of the information that would be provided by disclosure of mark to market pay leverage. Based on a sample of 873 companies with at least 15+ individual cases (one case is one three year period for one executive) and 10+ distinct three year periods, we found that grant date pay leverage explained 52% of the variation in mark to market pay leverage. Median grant date pay leverage, +0.08, is much lower than median mark to market pay leverage, +0.35, but the range of grant date pay leverage (0.93 from the 10th to the 90th percentile) is similar to the range of mark to market pay leverage (1.11 from the 10th to the 90th percentile) and the two leverage values are highly correlated (0.73). Four additional factors have a statistically significant impact on mark to market pay leverage (i.e., average percent of annual pay in options x the correlation of the company's gross and excess returns, average percent of annual pay in performance stock, average percent of pay in restricted stock x the correlation of the company's gross and excess return, and average percent of pay in cash incentive compensation), but these four additional factors only increase the explained variation in mark to market pay leverage from 53% to 62%.

### **Substantial history data is essential for investors to evaluate compensation**

Some commentators believe that "realizable pay" for a single three year period is sufficient to provide meaningful evidence of alignment. These commentators believe that expressing pay and performance in percentile terms for a single three year period provides evidence of alignment, i.e., pay is aligned with performance if the percentiles are similar, but unaligned if they are substantially different. In our view, it's impossible to make a reasoned judgment about correlation based on one observation and the two percentiles provide no measure of pay leverage.

### **Companies should be encouraged to provide supplemental graphs**

There are several reasons why a company might argue that the proposed pay versus performance graph does not give a complete picture of the company's pay for performance:

- Compensation is focused on absolute, not relative, performance.
- The company ties pay to an operating measure of performance.
- There is not a good measure of market compensation for the company's executives.
- The graph ignores the incentives created by stock owned at the start of the three year period.

I don't believe any of these arguments are compelling enough to give companies the option to substitute an alternative pay versus performance graph, given the substantial benefit to investors of having a common analysis for all companies. But these are good reasons why another graph might be informative to investors. I recommend that companies be required to provide the basic graph, but encouraged to provide supplemental graphs if they so desire.

### **Summary**

I recommend, for the pay versus performance disclosure required by Section 953 of the Dodd-Frank Act, the requirement of a log-log scatterplot of relative pay versus relative performance with the following features:

1. The graph is based on mark to market pay for the three year periods ending in each of the last twelve (or more) years; mark to market pay is the sum of:
  - a. Salary, annual bonus and "other" compensation during the three years,
  - b. The end of period value of equity compensation (including stock options, performance shares and restricted stock) granted during the three year period,
  - c. The end of period value of cash long-term incentive awards made during the three year period, and
  - d. The change in pension value over the three year period.
2. The graph includes all top 3 executives with continuous service in any three year period excluding executives promoted to CEO during the three year period.
3. Relative pay is mark to market pay divided by the company's estimate of average mark to market pay for the executive, i.e., the average mark to market pay of equal rank executives in peer companies of equal size.
4. Relative performance is ending shareholder wealth per share divided by the company's share price assuming the peer companies' average return for the three year period.
5. Relative pay and relative performance are shown on the same scale with a reference line on the main diagonal.
6. The graph shows the regression trendline with numeric reporting of the slope, correlation and intercept.

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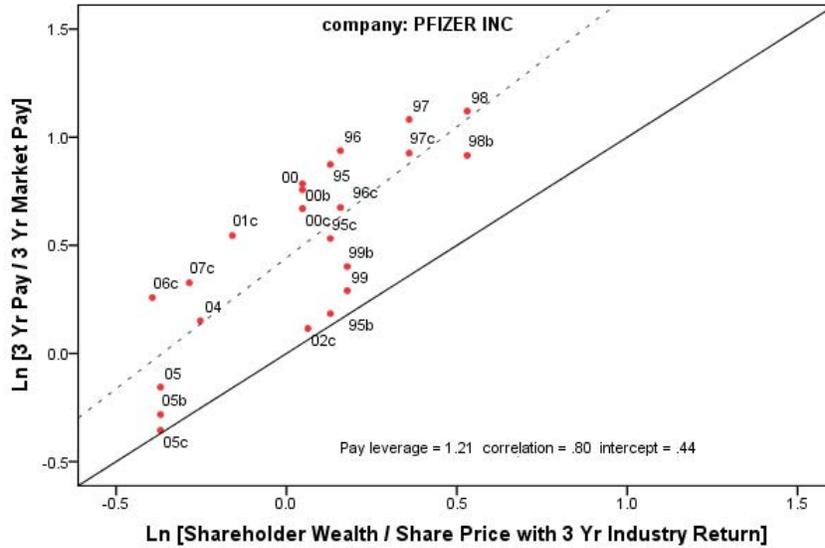
I appreciate the opportunity to comment and I hope this analysis is useful to the Commission in evaluating alternative approaches to pay versus performance disclosure.

Sincerely,

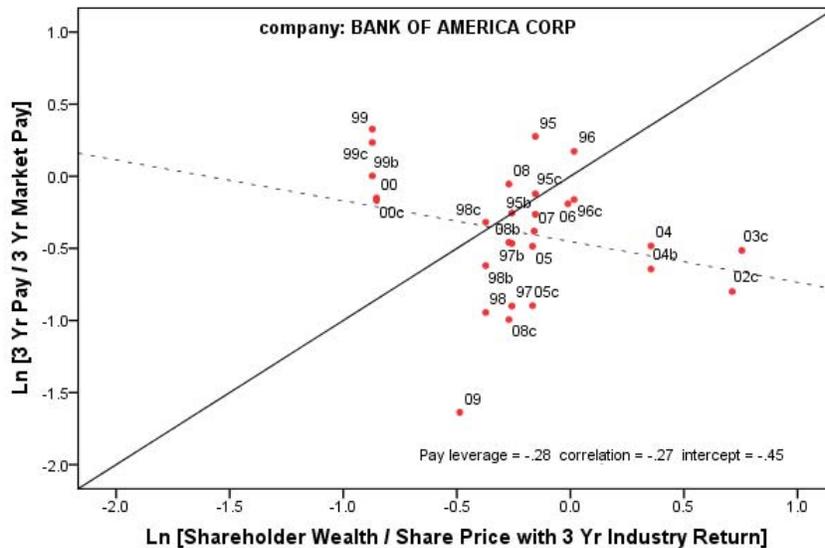
A handwritten signature in black ink that reads "Stephen F. O'Byrne". The signature is written in a cursive style with a large, stylized initial 'S'.

Stephen F. O'Byrne  
President

### 3 Yr Relative Pay vs Relative TSR



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

- "Six Factors That Explain Executive Pay (and its Problems)" (with Professor David Young of INSEAD) in the *Journal of Applied Corporate Finance* (Spring 2010)
- "What Investors Need to Know About Executive Pay" (with David Young) in *The Journal of Investing* (Spring, 2010)
- "Why Capital Efficiency Measures Are Rarely Used in Incentive Plans, and How to Change That" (with David Young) in the *Journal of Applied Corporate Finance* (Spring 2009)
- "Why Executive Pay Is Failing" (with David Young) in the *Harvard Business Review* (June 2006)
- "Top Management Incentives and Corporate Performance" (with David Young) in the *Journal of Applied Corporate Finance* (Fall 2005)
- *EVA and Value Based Management* (with David Young), McGraw-Hill (November 2000)
- "Does Value Based Management Discourage Investment in Intangibles?" in *Value-Based Metrics: Foundations and Practice*, edited by Frank J. Fabozzi and James L. Grant (2000)
- "EVA and Its Critics" in the *Journal of Applied Corporate Finance* (Summer 1999)
- "Executive Compensation" in the *Handbook of Modern Finance* (1997)
- "EVA and Market Value" in the *Journal of Applied Corporate Finance* (Spring, 1996)
- "Total Compensation Strategy" in the *Journal of Applied Corporate Finance* (Summer, 1995)

Prior to co-founding Shareholder Value Advisors in 1998, Mr. O'Byrne was head of the compensation consulting practice at Stern Stewart & Co. (1992-1998) and a Principal in the executive compensation consulting practice at Towers Perrin. Prior to joining Towers Perrin in 1979, he worked in the tax department at Price Waterhouse and taught mathematics at Loyola University of Chicago. Mr. O'Byrne holds a B.A. degree in political science from the University of Chicago, an M.S. in Mathematics from Northwestern University and a J.D. from the University of Chicago. He is the vice-chair of the Corporate Governance Committee of the New York Society of Security Analysts, a certified public accountant and a member of the Illinois bar.