



Davis Polk & Wardwell LLP 212 450 4000 tel
450 Lexington Avenue
New York, NY 10017

**Re: Comments on Subtitle E of Title IX—Accountability and Executive Compensation
under the Dodd-Frank Wall Street Reform and Consumer Protection Act**

November 16, 2010

VIA E-MAIL: rule-comments@sec.gov

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

Dear Ms. Murphy:

We are submitting this letter in response to the solicitation by the Securities and Exchange Commission (the “**Commission**”) for preliminary comments on Subtitle E of Title IX—Accountability and Executive Compensation of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “**Act**”). Set forth below are several recommendations we ask that the Commission consider in proposing rules to implement the relevant sections of the Act.

■ *Section 952. Compensation Committee Independence.*

Section 952(a) amends the Securities Exchange Act of 1934 (the “**Exchange Act**”) by inserting Section 10C, independence of compensation committees. Section 10C would require that the Commission direct the national securities exchanges and national securities associations to prohibit the listing of any equity security of an issuer (subject to certain exceptions) that does not comply with the requirements that each member of the compensation committee of the board of directors of an issuer be a member of the board of directors of the issuer and independent. The Commission’s rules must require that, in determining the definition of the term “independence” for this purpose, the national securities exchanges and the national securities associations consider relevant factors, including: (a) the source of compensation of a member of the board of directors of an issuer, including any consulting, advisory or other compensatory fee paid by the issuer to such member of the board of directors; and (b) whether a member of the board of directors of an issuer is affiliated with the issuer, a subsidiary of the issuer, or an affiliate of a subsidiary of the issuer.

We recognize that this provision appears to be modeled after similar requirements in the Exchange Act related to the independence of audit committees of boards of directors, which was promulgated pursuant to the Sarbanes-Oxley Act. Sarbanes-Oxley Act Section 301 expressly prohibited consulting, advisory and other compensatory fees and affiliation with the issuer in determining independence (“in order to be considered to be independent for purposes of this paragraph, a member of

an audit committee of an issuer *may not...*”), and therefore both Section 10A(m)(3) and Rule 10A-3(b)(1)(ii) of the Exchange Act promulgated thereunder contain similar explicit prohibitions. However, the Act is much less restrictive in terms of defining compensation committee independence, stating instead that the rules of the Commission shall require that the national securities exchanges and the national securities associations “*consider relevant factors*,” including certain fees and affiliations with the issuer.

We believe this distinction is important and should be reflected in the Commission’s rulemaking. The boards of directors of issuers listed with the New York Stock Exchange must already make an affirmative determination that a director has no material relationship with the listed company (either directly or as a partner, shareholder or officer of an organization that has a relationship with the company) before determining the independence of a director.¹ Similarly, Nasdaq corporate governance requirements indicate that boards have a responsibility to make an affirmative determination that no relationships exists that would impair independence.² The listing standards could be modified such that, in making these determinations, boards must also consider the relevant factors for compensation committees as prescribed in the Act.

If the Commission finds it necessary to instead adopt prescriptive rules similar to Rule 10A-3 for audit committees, we recommend that the Commission consider not precluding representatives of large shareholders to be considered independent members of issuers’ compensation committees. It is not unusual for some issuers, especially smaller issuers in certain industries or companies that have recently gone public, to have representatives of venture capital or private equity firms with sizeable investments in those companies as members of the compensation committee. The need for objective oversight of an issuer’s financial reporting from members of the audit committee is quite different from the role of the compensation committee to review and determine executive compensation against company and executive performance, and in fact, with respect to executive compensation, the interests of representatives of major shareholders are generally directly aligned with those of other shareholders. Disqualifying larger shareholders from being able to have representatives sit as independent members of a compensation committee is also inconsistent with the thrust of Section 951 of the Act, which provides shareholders with advisory votes on executive compensation.

- *Section 953. Executive Compensation Disclosures.*
 - *Section 953(a). Disclosure of Pay Versus Performance.*

The Act requires that Section 14 of the Exchange Act be amended to require, and that the Commission require by rule, each issuer to disclose in any proxy or consent solicitation material for an annual meeting of shareholders a clear description of any compensation required to be disclosed under Item 402 of Regulation S-K, 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. The disclosure may include a graphic representation of the information required to be disclosed.

The Commission rulemaking will require issuers to describe the relationship between compensation “actually paid” and “financial performance.” Those terms are not defined in the Act. As other areas of this Title in the Act clearly reference the disclosure of compensation required under Item 402

¹ NYSE Corporate Governance Standards, Rule 303A.02(a).

² Nasdaq Stock Market Corporate Governance Requirements, Rule 5605(a)(2).

of Regulation S-K,³ it appears that executive compensation “actually paid” does not mean total compensation as disclosed in the summary compensation table.

We recommend that the Commission adopt principles-based disclosure rules in implementing this requirement, consistent with its general approach for disclosure in the Compensation Discussion & Analysis (“**CD&A**”) section. Since the objective is to show the relationship between executive compensation paid and financial performance, the compensation elements subject to this analysis should only include those items that an issuer believes are based in some measure on attainment of company performance objectives during the relevant period. Items of compensation that are not relevant should not be included in this disclosure, such as pension accruals, deferred compensation earnings, issuer contributions to tax-qualified and non-qualified deferred compensation plans and perquisites and welfare benefits. Compensation based on performance objectives need not be limited to compensation that is solely derived from prescribed formulas, since executive compensation programs vary widely, and compensation committees often exercise discretion in determining even compensation that is based on the achievement of specified performance goals and targets. An issuer should be able to determine which compensation elements are based on performance and explain the rationale for why it included those elements in this analysis, and excluded others.

Consistent with this principles-based approach, the rules should not use strict definitions of issuer financial performance against which compensation paid is then evaluated. Each company should be able to describe the metrics used to measure its performance, against which compensation policies and practices are designed. While companies may assess pay against items that are directly aligned with an issuer’s financial statements, such as revenue or profit, they may also consider other measures not directly tied to their financial statements to be important to their financial performance, such as business unit performance, customer survey data, employee satisfaction, diversity efforts, industry-specific metrics or leadership qualities. Shareholders would benefit from understanding the different benchmarks that a company believes are necessary to achieve high financial performance and how its compensation practices are then aligned with those goals. This approach also complements the existing requirement in CD&A disclosure to discuss “corporate performance” and “issuer performance”, in the context of compensation policies and decisions, without strictly defining or otherwise restricting issuers to specific standards of performance, such as financial statement data.

This less restrictive definition of “financial performance” is consistent with the Commission’s approach to MD&A disclosure, on which CD&A is modeled. The Commission has long provided interpretation indicating that MD&A must provide information on matters on which a company’s executives focus in evaluating financial condition and operating performance, noting that “some of this information is itself non-financial in nature, but bears on companies’ financial condition and operating performance.” The Commission has recognized that “financial measures often tell only part of how a company manages its business” and the “key variables and other facts” that companies should consider disclosing in preparing MD&A “may be non-financial, and companies should consider whether that non-financial information should be disclosed.”⁴ Shareholders are capable of evaluating, and better served by, individually tailored disclosures rather than mandating a standard methodology. We are concerned that overly prescriptive rules may have the effect of imposing formal distinctions that either cause compensation committees to describe pay for performance differently from the way they actually consider those pay

³ See Section 951, Shareholder Vote on Executive Compensation Disclosures (“...as disclosed pursuant to section 229.402 of title 17, Code of Federal Regulations...”) and Section 953(b)(2) (“...For purposes of this subsection, the total compensation of an employee of an issuer shall be determined in accordance with section 229.402(c)(2)(x) of title 17, Code of Federal Regulations...”).

⁴ “Interpretation: Commission Guidance Regarding Management’s Discussion and Analysis of Financial Condition and Results of Operations,” Release Nos. 33-8350; 34-48960.

practices, or have the inadvertent consequence of influencing how they evaluate and determine executive compensation. Therefore we recommend that, as is currently the case, each company be permitted to develop its own disclosure about the link between compensation and performance that best suits its particular circumstances.

■ *Section 953(b). Additional Disclosure Requirements.*

The Act requires that each issuer disclose in any filing of the issuer described in Section 229.10(a) of Title 17, Code of Federal Regulations (a) the median of the annual total compensation of all employees of the issuer, except the chief executive officer; (b) the annual total compensation of the chief executive officer, and (c) the ratio of the amount described in (a) to the amount described in (b). We appreciate the difficulty that the Commission faces in light of the statutory language. Currently companies spend a significant amount of time and resources generating the information needed for determining total compensation to be disclosed for its named executive officers, much of which must be compiled on a manual basis because of the requirements and methodologies specified in the Commission rules. This process already raises questions and uncertainties as different interpretations can at times be reasonably applied in making the disclosure. For many companies, replicating the exercise to determine the median annual total compensation of all employees as calculated pursuant the Commission rules for disclosing named executive officer compensation under Regulation S-K will be highly costly and burdensome, with tremendous uncertainty as to accuracy. We understand that companies are justifiably concerned about the costs and burdens they would need to pay for, and bear, to accomplish the formidable data collection and calculation tasks for employees worldwide between the end of the year (as companies must wait until at least then for the basis of many calculations) and the annual meeting proxy statement.

We recognize that the intent of the statute is to require issuers to provide a ratio between the CEO's pay and the median pay of other employees. While we are not questioning the value of such a ratio, we are aware that the Commission would consider as part of its rulemaking a cost-benefit analysis, weighing the benefit to investors of the disclosure required against the cost imposed on companies in providing the information. In this case as the costs appear to be quite high, we make several suggestions which are designed to make the costs of data gathering more manageable while continuing to fulfill the mandate of the statute.

We recommend that the Commission permit companies to identify a single employee, via a sampling technique or other statistically reasonable method, among its employee base as the representative for median compensation. Companies should be able to use automated data already available to them, such as wages reported to the Internal Revenue Service. We also ask that the Commission consider excluding non-U.S. and part-time employees, in order not only to simplify the process for collecting the information, but also because the data by which the ratio is determined may be distorted by the inclusion of non-US and part-time employees. The information for non-U.S. employees is complicated by local severance benefits and pension rights and related accounting outside the U.S., particularly under government and statutory schemes which are common outside the U.S. In addition, many non-U.S. jurisdictions have privacy restrictions that may be implicated by the collection and use of this type of information. The inclusion of part-time employees, including new hires and terminated employees who did not work an entire fiscal year, would also distort the information (alternatively, such data could be allowed to be annualized). Once a representative employee has been identified, total compensation as required under Item 402 can be calculated for that individual, and then a ratio developed when compared against the CEO's total compensation. A simple method for calculation that can be explained clearly will permit more transparency and allow for better comparability across companies.

We also recommend that this ratio be required to be disclosed only in proxy statements for annual meetings and not other Commission filings, to avoid possible confusion for investors given that the

disclosure of executive compensation is not the primary purpose of those other filings. In addition, we ask that prior to any proposed rulemaking the Commission consider and review the concerns that will be raised by issuers in explaining the difficulty in applying this provision without appropriate regulatory flexibility. A longer transition time before effectiveness may also be necessary given the nature of the administrative burden imposed by this provision of the Act.

■ *Section 954. Recovery of Erroneously Awarded Compensation.*

The Act requires that the Commission, by rule, direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that does not comply with the requirement to develop and implement a policy providing for disclosure of the issuer's policy on incentive-based compensation and that, in the event the issuer is required to prepare an accounting restatement due to the material noncompliance of the issuer with any financial reporting requirement under the securities laws, the issuer will recover from any current or former executive officer who received incentive-based compensation (including stock options awarded as compensation) during the 3-year period preceding the date on which the issuer is required to prepare an accounting restatement, based on the erroneous data, in excess of what would have been paid to the executive officer under the accounting restatement.

We believe that the Commission can exercise its authority to interpret this regulation in several ways that would assist companies in their compliance efforts, make the recoupment policy transparent to investors and accomplish the Act's objective. Current Commission rules already define incentive-based compensation through the definition of incentive plans⁵ (the Grants of Plan-Based Awards table, for example, requires disclosure of both non-equity and equity incentive plan awards). Section 954(b)(1) of the Act indicates that the policy is designed to cover incentive-based compensation that is based on financial information required to be reported under the securities laws, while Section 954(b)(2) makes it clear that this also includes stock options awarded as compensation. The policy therefore should be limited to recovery of incentive-based compensation that is based on, or related to, publicly reported financial statements, including stock options as applicable.

This provision covers only those accounting restatements that occur as a result of material noncompliance by the issuer with financial reporting requirements under the securities law, eliminating restatements that may result due solely to changes in accounting policies or practices. As with other areas of the securities laws where materiality is invoked as a standard, we recommend that issuers make their own judgments as to whether material noncompliance with financial reporting requirements was the cause of a restatement in question and thereby triggers this recoupment policy. For clarity, the 3-year period should be the prior three fiscal years before the time that a Form 8-K is filed disclosing non-reliance on the company's financial statements, or if no Form 8-K is required, then the time that either a board of directors or management makes a determination that a restatement is required.

Nothing in the Act indicates that this provision is intended to operate retrospectively. To avoid costly litigation over applicability, the rules should make clear that, unless a company's existing recoupment policy otherwise permits, the policy required by the Act operates only on a prospective basis from the effective time of final implementing rules and should not require looking back to agreements, plans or contracts existing prior to such period, or to former officers who were employed under those prior agreements, plans or contracts.

⁵ Item 402(a)(6)(iii) of Regulation S-K ("The term incentive plan means any plan providing compensation intended to serve as incentive for performance to occur over a specified period, whether such performance is measured by reference to financial performance of the registrant or an affiliate, the registrant's stock price, or any other performance measure").

Most importantly, we urge the Commission to grant boards of directors sufficient discretion in determining how to implement the recoupment policies that they adopt. Boards should be entitled to evaluate the benefits of recoupment against an assessments of the costs involved. For example, in situations where efforts to recoup amounts will end up being more costly than the possible recoupment, it would be to the shareholders' detriment to pursue those cases. Companies should disclose the boards' determinations in such an event. The Treasury Department has recognized the importance of providing for this type of discretion in the clawback requirement it adopted for TARP companies: "The TARP recipient must exercise its clawback rights except to the extent it demonstrates that it is unreasonable to do so, such as, for example, if the expense of enforcing the rights would exceed the amount recovered."⁶

Boards of directors should also be provided with the ability to determine the "excess of what would have been paid to the executive officer under the accounting restatement" as required under the Act. This is not defined in the Act, and we believe that it would be best left up to each board of directors to determine the excess payment under this provision as suitable to the individual situation. It may prove quite difficult to measure the value of the prior award an executive received in order to ascertain the amount that would have otherwise been paid under the restatement. With equity awards for example it will be unclear whether these amounts should be based on the grant date fair value or the realized value, and whether the prior award given should be measured against the compensation for the exact target achieved, or the actual payout provided after discretion was exercised by compensation committees to either increase or decrease the amount. For example, if under restated results a performance target would have been missed by a *de minimis* amount, it does not automatically mean that the board, had it known at the time it made the prior compensation decision, would have reduced the compensation element linked to this target to zero simply because the target was not achieved. It would be just as reasonable to believe that the board would have decreased the compensation paid in equal proportion to the amount missed, or otherwise exercised its discretion such that the executive would have received some portion of the compensation that was tied to the performance target. For these reasons, it will not be obvious how to determine the "excess" in every case. Since it was the responsibility of the compensation committee to make the prior compensation decision, the compensation committee is in the best position to assess what actions it would have taken under restated results.

The compensation committee should also be entitled to consider that the executive has already paid taxes on the compensation previously received, or has spent or allocated those funds. Particularly where no individual malfeasance occurred, it would in many cases be unjust to expect an immediate return to the company of the compensation, especially pre-tax compensation, that was paid to the executive. It could unduly punish an executive who is a high performer for the company and had no involvement with the actions that led to the restatement. Boards of directors may decide, in the company's best interests, to recover the amounts over time, or even to recoup the amounts from future pay. For these reasons, we recommend that boards of directors should be given the ability to exercise discretion in determining whether to pursue recoupment, the amount to be recovered and the and the best means to accomplish recovery.

* * *

⁶ "TARP Standards for Compensation and Corporate Governance," the Department of the Treasury, 31CFR Part 30, RIN 1505-AC09.

We appreciate the opportunity to participate in this process, and would be pleased to discuss our comments or any questions the Commission may have with respect to this letter. Any questions about this letter may be directed to David Caplan, Ning Chiu, Edmond FitzGerald, Kyoko Takahashi Lin, Barbara Nims or Richard Sandler at 212-450-4000.

Very truly yours,

DAVIS POLK & WARDWELL LLP