

Via E-Mail

April 29, 2019

Vanessa Countryman
Acting Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Re: Petition for Rulemaking Regarding Disclosures on Use of Non-GAAP Financials in Proxy Statement CD&As

Dear Madam Secretary:

The Council of Institutional Investors respectfully submits this petition to the Securities and Exchange Commission (Commission) requesting that the Commission (1) initiate a rule change to amend Item 402(b) of Regulation S-K [17 CFR 229.402(b)] under the Securities Act of 1933 (Securities Act) to eliminate Instruction 5; and (2) revise the Division of Corporation Finance’s Compliance & Disclosure Interpretations on “Non-GAAP Financial Measures” consistent with the aforementioned amendment and to provide that all non-GAAP financial measures presented in the proxy statement Compensation Discussion & Analysis (CD&A) are subject to the requirements of Regulation G [17 CFR 244.101-102] and Item 10(e) of Regulation S-K [17 CFR 10(c)] and that the required reconciliation shall be included within the proxy statement or made accessible through a hyperlink in the CD&A.¹

The use of non-GAAP or “adjusted” earnings in earnings reports is widespread and on the rise. Research by *The Analyst’s Accounting Observer* found that 386 companies in the S&P 500 index reported “adjusted” earnings in 2016, up from 264 in 2009.² In both years, “adjusted earnings” were on average about one third higher than reported GAAP earnings. Exclusions included costs of equity grants, asset impairments, intangible amortization and restructurings.

These alternative measures of performance also are prevalent in executive compensation targets as presented in the proxy statement CD&A. In some cases, these measures may be useful for

¹ CII is a nonprofit, nonpartisan association of public, corporate, and union employee benefit funds, other employee benefit plans, state and local entities charged with investing public assets, and foundations and endowments with combined assets under management of approximately \$4 trillion. Our member funds include major long-term shareowners with a duty to protect the retirement savings of millions of workers and their families. Our associate members include a range of asset managers with more than \$35 trillion in assets under management. For more information about the Council of Institutional Investors (CII), including its members, please visit CII’s website at <http://www.cii.org/members>.

² Unpublished data, on file with CII.

incentivizing prudent executive decisions benefitting long-term investors, and we are not asking that companies be prevented from using non-GAAP financial criteria for awarding compensation. But GAAP is the standard, and deviations need to be clear and put in context. This is as true for proxy statements as it is for 8-Ks, 10-Ks and earnings releases. Indeed, the need for clarity is especially appropriate in the CD&A context because shareholders cast advisory votes on executive compensation regularly – every year at most public companies.

The SEC’s Regulation G requirements provide an important investor protection against misleading information about performance. Excluding the CD&A disclosures on compensation targets from the Regulation G requirements results in CD&A references to non-GAAP financials that are not always clear, and may mislead investors. We believe the SEC should fix this anomaly in its guidance on use of non-GAAP financials.

Changes Requested

CII requests the following:

- A rule change to eliminate Instruction 5 to Item 402(b)³
- Change in the Compliance & Disclosure Interpretations on Non-GAAP Financial Measures consistent with the change above, and also to provide that the registrant should include the required GAAP reconciliation and other information in the CD&A itself, or in an appendix to the proxy statement or hyperlink to the relevant section of the 10-K.⁴

The Problem

Companies that use executive compensation targets based on non-GAAP financial measures currently are not required to adequately disclose how those measures relate to GAAP. This information should be presented in proper context, within the proxy statement CD&A. This is clearly not being done by many companies using non-GAAP or “adjusted” earnings and other non-GAAP measures to help determine how executives are paid.

Research shows that companies using adjusted earnings to depict substantially better pictures of performance relative to GAAP frequently incorporate adjusted earnings into executive compensation practices. In 2016, adjusted earnings of 28 companies in the S&P 500 showed substantial profits, even though their GAAP earnings were actually losses. Another 37 companies reported adjusted earnings that were more than 100% higher than their GAAP earnings. Of these 65 companies, 62 used adjusted earnings as compensation criteria in their CD&As, according to research by Robert Pozen at MIT’s Sloan School of Management. Pozen found that, while in most cases compensation committees used the same adjustments as did

³ Item 402(b) (see <https://www.law.cornell.edu/cfr/text/17/229.402>) explains disclosure requirements for the “compensation disclosure and analysis” section of the proxy statements. Instruction 5 provides that: “Disclosure of target levels that are non-GAAP financial measures will not be subject to Regulation G (17 CFR 244.100 - 102) and Item 10(e) (§ 229.10(e)); however, disclosure must be provided as to how the number is calculated from the registrant’s audited financial statements.”

⁴ See Question 108.01, “Compensation Discussion and Analysis/Proxy Statement,” to CD&I on “Non-GAAP Financial Measures,” at <https://www.sec.gov/divisions/corpfin/guidance/nongAAPinterp.htm>.

management in other filings that were subject to Regulation G, in some cases compensation committees used somewhat different definitions of adjusted earnings.⁵

These findings in 2016 continued patterns from prior years. In 2015, for example, two-thirds of the companies in the S&P 500 index reported adjusted earnings exceeding their GAAP income. After analyzing the proxy statements of these companies, Pozen and co-author S.P. Kothari concluded in an article in the *Harvard Business Review* that “most compensation committees in firms with substantial differences between GAAP and non-GAAP numbers used the non-GAAP ones to set CEO pay.” At those companies, wrote Pozen and Kothari, “adjusted earnings or adjusted operating cash flow determined at least 40% of either annual cash bonuses or long-term stock awards, or both.”⁶

CII has not conducted a comprehensive study on 2018-19 proxy statements, but we see continuing opportunities for better disclosures about use of non-GAAP measures related to performance targets.⁷ At the same time, we see that some companies using non-GAAP metrics

⁵ Unpublished data, on file with CII. See also Nicholas Guest, S.P. Kothari and Robert Pozen, “High Non-GAAP Earnings Predict Abnormally High CEO Pay,” January 2019, at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3030953&download=yes.

⁶ Robert C. Pozen and S.P. Kothari, “Decoding CEO Pay,” *Harvard Business Review* (July-August 2017), at <https://hbr.org/2017/07/decoding-ceo-pay>.

⁷ For example:

- **Abbott Laboratories** (March 15, 2019, proxy statement): The CD&A features various adjusted metrics, including adjusted diluted EPS, which excludes “specified items” that are not comprehensively named, as far as we can see, although “intangible amortization expense” and “expenses related to restructuring actions or business acquisitions” are offered as examples. The proxy statement offers no reconciliations to GAAP, and does not link to or reference such reconciliations. Abbott does provide certain reconciliations in its quarterly earnings releases, but it is not clear if these are for the same adjusted figures.
- **Advanced Micro Devices** (March 21, 2019, proxy statement): Non-GAAP measures used in setting compensation and referenced in the CD&A include non-GAAP net income. In the only explanation we see, AMD indicates “our ‘adjusted non-GAAP net income’ was calculated by adjusting our fiscal 2018 GAAP net income for non-GAAP financial adjustments and amounts accrued for the fiscal 2018 bonuses.” This explanation is largely circular. And we see no reconciliations to GAAP, and no links or references to other documents with such reconciliations. AMD does provide reconciliations of non-GAAP measures, including non-GAAP net income, in its quarterly earnings releases, but it is not clear if this is the same adjusted net income as used for the compensation metric before the further adjustment to exclude bonuses (for which we do not see any reconciliation at all).
- **Altice USA** (March 21, 2019 proxy statement): The company uses “adjusted EBITDA” in setting executive compensation, and defines it in the CD&A, but provides no reconciliation to GAAP in the proxy statement, or link or reference to such a reconciliation elsewhere. Altice does provide a reconciliation of adjusted EBITDA to net income in its earnings releases, and notes that it uses two adjusted EBITDA calculations—one excluding capital expenditures. It is not clear in the proxy statement CD&A whether adjusted EBITDA as cited there is the same as either adjusted EBITDA calculation used in earnings releases.
- **Cisco** (October 24, 2018 proxy statement): Compensation targets include GAAP revenue with certain exclusions, and GAAP operating income with certain exclusions. These exclusions are described in the CD&A, but there is no reconciliation to GAAP in the proxy statement, or any link or reference to such a reconciliation elsewhere. The company’s quarterly earnings releases do provide operating income reconciliations, but the earnings releases for the 2018 fourth quarter (and full fiscal year 2018) provided a list of exclusions worded differently from the exclusions list in the proxy statement. We would guess that the adjusted operating income in Cisco’s quarterly releases is different from “GAAP operating income with certain exclusions” in its CD&A, but we cannot tell for sure.

related to compensation targets defined such metrics in their CD&As and explained how they differ from GAAP.⁸ We would emphasize that some CII members would argue with the substance of certain adjusted metrics used by these latter companies (for example, the exclusion of stock-based employee compensation⁹). But all we seek with this petition is a requirement for clear explanations and GAAP reconciliations that would permit a shareholder to understand the company's approach and factor that into its say-on-pay vote and/or buy/sell decision, and potentially engage board members on the shareholder's concern.¹⁰

Rationale for Proposed Changes

We do not believe there is a reasonable basis for excluding executive pay targets as disclosed in the CD&A from what the SEC deems elsewhere to be necessary disclosures on adjusted financial measures. Textual and quantitative reconciliation of the differences between adjusted earnings

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- **Cogent Communications Holdings** (March 15, 2019, proxy statement): The CEO's annual incentive is based half on "adjusted EBITDA growth." The company does not explain in the proxy statement how EBITDA is adjusted. Cogent does provide a definition of adjusted EBITDA and a GAAP reconciliation in its quarterly earnings releases, but there is no link or reference to these in the CD&A. From our calculations, it appears that the adjusted EBITDA figure used for compensation is the same as that used in quarterly earnings releases, but a shareholder should not have to guess where the company might publish such data, and then do calculations to determine if this is the same adjusted EBITDA metric.
 - **Oracle** (Sept. 26, 2018, proxy statement): Various non-GAAP targets are used in setting executive compensation, including non-GAAP pretax profit, which is defined, but with no reconciliation to GAAP and no link or reference to reconciliations elsewhere. We do find reconciliations in quarterly earnings releases to "non-GAAP pretax profit," but it is not clear that these are for the same adjusted figures.
 - **Revlon** (April 23, 2019, proxy statement): Two top executives were compensated in part based on "certain Adjusted EBITDA targets," with no definition beyond that, and no link or reference to GAAP reconciliations elsewhere. We do find GAAP reconciliations in quarterly earnings releases for adjusted EBITDA, but it is not clear that this is the same adjusted metric.

⁸ See, for example, proxy statements of the following companies, all of which explain non-GAAP metrics used in compensation targets, and all of which provide reconciliations to GAAP in their proxy statements: Blackbaud (April 24, 2019); Cognizant Technology Solutions (April 18, 2019); Devon Energy (April 24, 2019); FedEx (August 13, 2018); IBM (March 11, 2019); Starbucks (Jan. 25, 2019); Take-Two Interactive (July 26, 2018). We note that some other companies reference reconciliation to GAAP in other documents, but do not use hyperlinks, which we think should be required (see for example HP Inc. [Feb. 26, 2019]).

⁹ See, for example, *Executive Stock Options: Should the Internal Revenue Service and Stockholders Be Given Different Information: Hearing Before the Perm. Subcomm. on Investigations of the Comm. on Homeland Sec. & Governmental Affairs of the U.S. Senate*, 110th Cong. 147 (June 5, 2007) (full text of statement by Jeffrey P. Mahoney, General Counsel, CII), <https://www.govinfo.gov/content/pkg/CHRG-110shrg36611/pdf/CHRG-110shrg36611.pdf> (failure to report stock compensation as an expense distorts "reported profitability and other key financial metrics").

¹⁰ We do not want our petition's narrow focus to prejudice our prerogative to bring up a separate issue that we may raise later with the SEC Division of Corporation Finance ("Division"). In its answer to question 108.01 of SEC Compliance & Disclosure Interpretations on presentation of Non-GAAP Financial Measures (at <https://www.sec.gov/divisions/corpfin/guidance/nongAAPinterp.htm>), the Division indicates that Instruction 5 to 402(b) "is limited to CD&A disclosure of target levels that are non-GAAP financial measures." The Division states that, "If non-GAAP financial measures are presented in CD&A or in any other part of the proxy statement for any other purpose, such as to explain the relationship between pay and performance or to justify certain levels or amounts of pay, then those non-GAAP financial measures are subject to the requirements of Regulation G and Item 10(e) of Regulation 10-K." We have observed some companies that, in the context of proxy statement discussion of company performance, cite non-GAAP financial measures without appearing to provide "equal or greater prominence" to the most directly comparable GAAP measure, as the Division's current guidance calls for.

and GAAP is clearly feasible in the CD&A, since such information was included in the proxy statements of roughly half of the 62 companies with large differences that used adjusted earnings as compensation criteria in 2016, and we see this in more recent proxy statements as well.

The CD&A is the most important source used by investors in evaluating executive compensation, and in deciding how to vote on advisory votes on executive compensation mandated by the Dodd–Frank Wall Street Reform and Consumer Protection Act.¹¹ The CD&A also informs investor understanding of a corporation’s governance more generally, and in voting on election of directors.

Again, we wish to emphasize that we believe in some cases non-GAAP measures of performance may incentivize prudent executive decisions benefitting long-term investors. However, CII has heard from its members increasing concerns about complexity in executive pay structures, and challenges in understanding compensation and its links to performance. It is imperative that the SEC require at least the level of transparency in proxy statement CD&As as in other corporate documents.

We look forward to discussing this petition with commissioners and the staff. In the meantime, if you have any questions or need additional information, please contact Ken Bertsch or Jeff Mahoney at 202.822.0800 (ken@cii.org; jeff@cii.org).

Sincerely,



Kenneth A. Bertsch
Executive Director



Jeffrey P. Mahoney
General Counsel

cc: The Honorable Jay Clayton, Chairman, U.S. Securities and Exchange Commission

¹¹ Dodd–Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111th Cong. § 951 (2010), <https://www.govinfo.gov/content/pkg/PLAW-111publ203/html/PLAW-111publ203.htm>. We believe a GAAP reconciliation to non-GAAP information contained in the CD&A is necessary for investors to make a fully informed vote on say-on-pay.

The Honorable Commissioner Robert J. Jackson, Jr., U.S. Securities and Exchange Commission

The Honorable Commissioner Hester M. Peirce, U.S. Securities and Exchange Commission

The Honorable Commissioner Elad L. Roisman, U.S. Securities and Exchange Commission

Mr. William H. Hinman, Director, Division of Corporation Finance, U.S. Securities and Exchange Commission

Mr. Rick Fleming, Investor Advocate, U.S. Securities and Exchange Commission

Ms. Anne Sheehan, Chairman, SEC Investor Advisory Committee