

What You Need to Do Today to Ensure Smarter Compensation Disclosure Tomorrow

Managing the executive compensation disclosure process has become more challenging than ever as companies remain under ever-increasing pressure to demonstrate a crystal-clear correlation between pay and performance. To get some insights into how to understand and handle this process effectively, we talked with Myrna Hellerman, Senior Vice President and executive pay expert with Sibson Consulting, a division of Segal (www.sibson.com), a global, independent benefits, compensation and human resources consultancy.

“One important point to keep in mind is the degree of increased transparency that is required in this new world, particularly regarding the SEC [Securities and Exchange Commission] disclosure rules,” she stresses. “It’s good to get a perspective on the interesting developments that have taken place regarding the CD&A [Compensation Discussion and Analysis] portion of the process,” Hellerman points out.

Pay pitfalls led to economic disaster. “After the rules passed four years ago, the SEC went back and reviewed the CD&As of hundreds of companies and commented on those companies’ disclosures. The SEC has really followed through on and enforced its rules—and in most cases, what it has asked for appears to be very reasonable,” Hellerman says.

“Originally, the SEC contemplated an even greater disclosure with respect to top executives. Early drafts of the SEC rules detailed disclosure beyond the Named Executive Officers to a group of the next highest-paid executives. However, companies expressed deep concern that some of the information they were being required to disclose would jeopardize their ability to attract and retain these individuals,” she continues. “So the SEC then said, essentially, ‘Let’s not get hung up on that issue right now; we’ll revisit it in the future.’”

However, developments on the economic front have painfully demonstrated the importance of broader disclosure. “Now we are going through an economic crisis of unprecedented proportions. If you look at the disclosures of the companies that led the economic crash and made news, you’d see that what they disclosed for their top five

most highly paid executives and the numbers made sense. While the numbers were big, there was nothing that would indicate that those payouts would cause the downfall of an organization," Hellerman suggests.

"However, the reality is that much of the risk-oriented behavior that caused some of the financial institutions to fail was related to the way people at the next level down were compensated," she points out. "So the SEC has revisited the need to look at the next level down, because often it's not the named executive officers of a corporation who receive the biggest pay packages based on a high level of risk-taking."

New disclosure regulations in the offing. SEC recently issued expanded disclosure requirements that will focus on how the next level down is being compensated and on the kind of risk/reward relationships that exist at companies.

"Driven by the economic crisis, the SEC proposes additional disclosure on how pay programs operate and what drives performance for the next level down," Hellerman states. "Once the new rules have been promulgated and approved, the results of this expanded disclosure are expected to be part of next year's proxies. We can expect that this expanded disclosure will provide very revealing insights into how executives are encouraged to take unreasoned risks."

Better alignment with "say on pay." One outcome of the expanded SEC disclosure regulations will be a closer alignment with "say on pay," Hellerman points out. "We can expect 'say on pay' legislation, probably before the end of this year. In Congress there's a push for approving the 'say on pay' bill. If we're going to have say on pay, investors will need more information.

"The earlier regulations regarding CD&A did not have a tight fit with 'say on pay' but now there will be such fit," she continues. "The SEC's new rules will help investors and institutional advisors to understand even more about how people are paid."

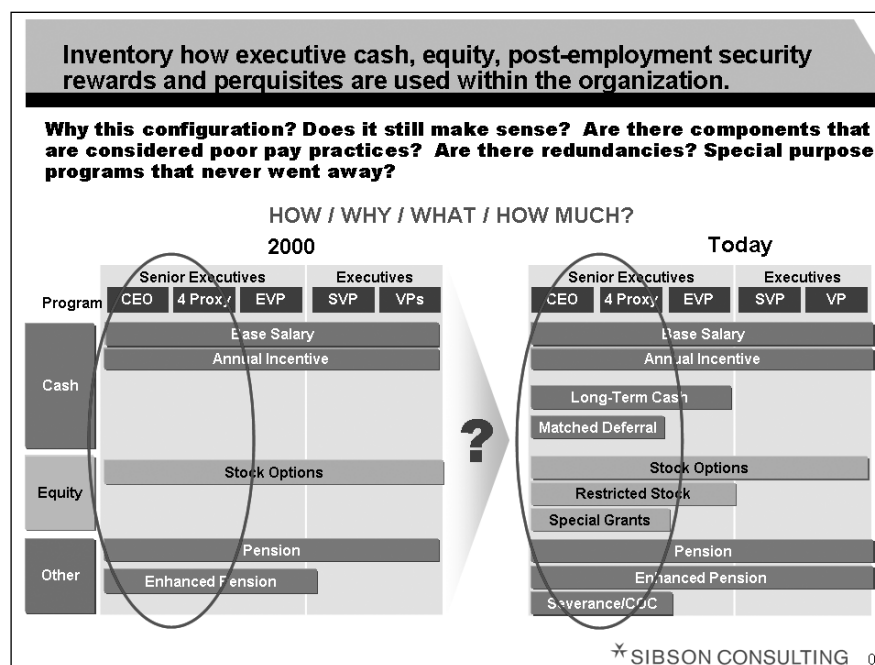
Time to take inventory. "The best way to ensure that your pay programs for your most highly paid people will meet SEC disclosure regulations and investor demands is to first inventory how executive cash, equity, post-employment security rewards and perquisites are currently being used within the organization," Hellerman advises (see Figure 1). Ask the following questions:

- *Why do we have this configuration?*
- *Does it still make sense?*
- *Is the way we establish performance goals sound? [Missing in graph]*
- *Are there components that are considered to be poor pay practices?*
- *Are there redundancies?*

- Are there “special purpose” programs that never went away?

“With the coming year being a year of greater disclosure, you must know what your pay practices are, how much sense they make and why these programs continue to support your company’s strategy and mission,” Hellerman stresses. “In general, organizations and compensation committees want to act in good faith,” she adds. “However,

they often have no history or information on why certain pay programs exist because the company has just added elements over the years without documenting why a program was implemented. That’s why it’s so important to know what you’re doing and why—and be able to defend it in the context of business and performance strategy.”



Poor pay practices to avoid. RiskMetrics Group (www.riskmetrics.com), a shareholder advisory group, annually issues its *U.S. Corporate Governance Policy Report*, which includes a list of poor pay practices companies need to avoid. Know what these practices are, Hellerman stresses. Pay practices you need to avoid include the following:

- Egregious perquisites (cost and/or tax reimbursement)
- Abnormally large incentive payouts without justifiable performance linkage or proper disclosure
- “Sweeteners” that increase payout value of SERPs (e.g. additional years of service credited, value of incentive pay included in calculation)
- Egregious severance and/or change-in-control provisions (e.g. tax gross-ups, single triggers)
- Dividends or dividend equivalents on unvested performance shares or units
- Excessive differential between CEO total pay and that of the next highest paid NEO

- *Above-market returns or guaranteed minimum returns on deferred compensation*
- *Irresponsible use of company stock (e.g. collateral for margin loans, hedging activities)*

"You may have to make changes in light of RiskMetrics's 'laundry list' of poor pay practices. Companies that do not do this will get negative advisory votes not only on 'say on pay' but also with respect to the directors who serve on the Compensation Committee. This can be very embarrassing," Hellerman notes.

But keep this in mind: "Just because you have a certain pay practice or give a certain perquisite doesn't mean it's wrong; it may make sense in your organization. However, you must be able explain clearly in your proxy why you have it," Hellerman notes. "For example, having a corporate plane is generally frowned upon. But for a company with facilities in remote locations that are not served by nearby commercial flights, it may make sense—and be perfectly justifiable—to maintain a plane for frequent executive travel to distant sites.

"Being able to explain things like this in plain English will help you gain shareholder understanding for pay and other compensation-related decisions," she continues. "For every decision you make, consider whether you can write in 10 or fewer words why you do this. That's what institutional investors will be looking at in determining whether they will give a yea or nay vote in how your company manages its pay programs."

Tip for success: Pay for performance, don't "pay for failure." "As you look at your pay program, make sure you are not inadvertently 'paying for failure,' " Hellerman advises. "Some pay programs may appear to be performance-related but they're really just rewarding people for sticking around for a longer period of time. For example, a company sets up a particular award and then guarantees that the person will get half the reward—even if performance targets are not met—as long as the person stays on board for a few more years. Those kinds of nonperformance-related provisions, while common in the past, are not viewed favorably these days."

Manage pay-related risk. "As you look at your pay practices, consider the risk associated with each element of your pay-plan design," Hellerman advises. "Managing risk is a critical part of effective pay-plan design and will help ensure that nothing untoward will creep into your disclosure."

For 2009, companies took a variety of measures to reduce risk, Hellerman notes, including the following:

- *Significantly temporarily reducing executive base pay through the end of the year;*
- *Suspending annual and/or long-term incentive plans;*
- *Reducing annual incentive payout opportunities across the board for all participants;*

- *Changing performance metrics (e.g., dropping growth metrics, emphasizing cash flow/ earnings and other strategic objectives);*
- *Modifying incentive payout curves to ensure that some payout is attainable;*
- *Introducing shorter performance cycles (e.g., six months), particularly in annual incentives;*
- *Exchanging stock options; and*
- *Suspending 401(k) matches and corresponding SERP matches.*

The bottom line: "A lot of thought and agony went into decisions agreed upon by compensation committees in 2009, but it is important to recognize that there are no quick fixes," Hellerman stresses. "Start making well-thought-out strategic decisions about what will stay and what will go for next year's executive compensation program. Look at how what you have matches up with what are viewed as unacceptable practices, so when you reach decisions for the new year, you will know what actions you need to take to have a CD&A that is responsive to the demands of both regulators and shareholders, create pay programs that are affordable to your company, and continue to treat your executives fairly in relationship to the value of their contribution to enterprise success."