Feature Story

By Philippa Maister

Pay back

The SEC takes action to address concerns about executive compensation

The contented purrs of the CEOs that many members of the public and some investors see as overpaid fat cats are turning into angry hisses after the Securities and Exchange Commission (SEC) released a proposed rule to force companies to disclose every last cent their executives make, justify their earnings in terms of their performance and compare those numbers to what competitors are paid.

It's a rule some legal experts say could prove a fertile source of shareholder litigation and another headache for general counsel. If, as expected, a final rule is issued this year, it would go into effect for the 2016 proxy season.

Hisses could turn to snarls as two related proposed rules—on clawbacks and the CEO/median pay ratio—raise further risks. In each case, the Dodd-Frank Act mandated the SEC to take action, despite the loud misgivings of some Commissioners.

Under the Dodd-Frank Act, the SEC was directed to come up with some way for companies "to disclose in a clear manner the relationship between executive compensation actually paid and the financial performance of the registrant, taking into account any change in the value of the shares of stock and dividends."

SEC, CEOs and TSR

Though two Commissioners strongly opposed it, the proposed rule would require companies to display in their proxy statements executive pay and performance information for the company and for peer companies using a specific table format that may be supplemented with narrative or a graph. (*see chart on next page*) The company's financial performance—and hence that of the CEO and other executives—would be measured based on total shareholder return (TSR). Large corporations would have to provide the data for the five most recent fiscal years, while smaller companies would only need to provide data on the past three years.

A CEO's actual pay would have to be specified in detail, adding equity awards that vested and the cost of pension benefits to the information already required in the company's Summary Compensation Table. The compensation paid to other executive officers named in the proxy statement would be provided as an average for the named officers.

"[Total shareholder return] is a good measure because it can't be fudged and shareholders are very much tied to it. But there are other performance measures and drivers."
—Yonat Assayag, partner, ClearBridge Compensation Group

The SEC says these disclosures would help shareholders in deciding whether to approve "say-on-pay" votes. It chose TSR as the measure of performance on the grounds that it can be objectively determined from the company's share price, makes it easier to compare pay-for-performance across competitors in the company's peer group, and is already familiar to investors.

However, acknowledging that TSR may not be the only measure compensation committees use in measuring a CEO's performance, the rule would allow companies to explain other criteria they use in setting CEO pay.

Considerable commentary

Comments on the proposed rule flowed in. In general, companies were more likely to criticize the prescriptive nature of the proposed rule and argue for flexibility in explaining their compensation policies, while shareholder groups, pension funds and institutional investors were more supportive of the rule.

PAY VERSUS PERFORMANCE TABLE

Year	Summary compensation table total for PEO	Compensation actually paid to PEO	Average summary compensation table total for non-PEO named executive officers	Average compensation actually paid to non-PEO named executive officers	Total shareholder return	Peer group total shareholder return
(a)	(b)	(c)	(d)	(e)	(f)	(g)

SOURCE: FEDERAL REGISTER/VOL. 80, NO. 88 P 26333

"The proposal attempts to create in a single format comparability across companies with respect to matters that are inherently unique to each company," wrote James R. Peacock, deputy general counsel of Celanese Corp., expressing a common opposing view. In contrast, Jeff Mahoney, general counsel of the Council of Institutional Investors, considered that the SEC had generally "struck the appropriate balance between prescribing rules…and allowing registrants to disclose pay-versus-performance information most relevant to shareowners."

Several commenters also argued that focusing on TSR could encourage CEOs to focus on short-term results. BlackRock Inc., which claims to vote at 15,000 shareholder meetings annually, said a focus on short-term TSR would incentivize management "to prioritize return of capital to shareholders, via either dividends or buybacks." Indeed, Bloomberg Business reported in July that 11 of the 15 non-financial companies that spent the most on buybacks in 2014 base part of CEO pay on TSR or earnings per share or both.

Another risk of focusing on TSR is that companies may adjust their compensation policies to suit this approach instead of what is best for the company, says Michael L. Hermsen, a partner with Mayer Brown in Chicago.

"TSR is a good measure because it can't be fudged and shareholders are very much tied to it. But there are other performance measures and drivers," says Yonat Assayag, a partner with ClearBridge Compensation Group. "CEOs are thinking of the stock price and what they need to do to drive the business, improve profitability, and grow revenues whether organically or through acquisitions. These are what drive them to perform."

Fiscal fallout

Assayag notes that most of the information the rule requires already exists, but is packaged differently. "The challenge will be to tell the right pay-for-performance story, so most companies will want to include supplemental disclosures," she says. The task will be even more important because the table format is the easiest for investors to digest.

Experts advise companies to begin now to prepare for the final rule, for example, by running simulations to see what additional data is needed. Robin Ferracone, CEO of executive compensation consultant Farient Advisors, says her firm is working with all of its clients to calculate pay-for-performance numbers as prescribed by the SEC proposal. After reviewing hundreds of proxy statements, she notes that about one-third of companies already have a discussion of how they set pay for performance with rigorous standards.

Another challenge for GCs will be determining when an equity award has vested. Hermsen says, "The way they used it in the rule seems very simplistic and many compensation systems are more complicated. We hope there will be changes or at least clarification in the final rule."

Companies will also need to consider how proxy advisors could use the rule in relation to TSR. "Are they simply going to look at the mandated information and make recommendations on votes based on this one piece of information?" Hermsen asks.

Indeed, American Tower International, Inc., alone among commenters, urged the SEC to go even further. General counsel Edmund DiSanto urged the SEC to mandate that investment advisors could rely on proxy advisory firms "if and only if" such firms use the SEC methodology. He argued it made little sense to require companies to use one method while proxy advisors recommended say-on-pay votes "based on an entirely different valuation of options, an inconsistent TSR computation, and/or a non-conforming peer group."

Hermsen also sees a litigation risk ahead, based on a misleading disclosure, if the pay for performance table does not support compensation.

A number of commenters requested the SEC to abandon the requirement for comparison peer groups, which is not in the statute. Kyoko Lin, a partner with Davis Polk & Wardwell, says even if companies place a low weight on TSR in their compensation schemes, they will still have to explain it in relation to their peers' TSR and will have to guess at the reasons for any differentials.

Clawing back

On July 1, the SEC proposed a "clawback" rule—again adopted over the objections of two Commissioners—that promises more headaches for compensation committees. Unlike the pay-for-performance proposal, which would not

touch emerging or foreign companies, the clawback rule would apply to them as well.

The rule is intended, according to Commissioner Kara M. Stein, to discourage artificially inflated financial statements. "This is done by requiring companies to clawback incentive-based executive compensation any time there are material errors in the company's financial statements—not just when there is misconduct," Stein says. Incentive-based compensation includes stock price and TSR.

In the event of a restatement, companies would also have to disclose the amount of any compensation overpaid—a task Lin says will be difficult—and the names of any executives from whom it did not seek a clawback.

To enforce the rule, the nation's stock exchanges would have to adopt, within 90 days of the final rule, listing standards requiring all listed companies to adopt and comply with a written clawback policy. The policy would also have to be attached to the company's annual report.

The golden ratio

The SEC's third proposed rule—again approved by a 3-2 vote—requires companies to disclose the ratio of the compensation of its CEO to the median compensation of its employees. Each company will have to figure out the best way to do this.

Adding to the challenge, the rule applies to all employees, including full-time, part-time, temporary, seasonal, and non-U.S. employees.

The ratio would have to be published in registration statements, proxy and information statements, and annual reports. Companies would be free to supplement the disclosure with narrative discussion or additional ratios.

Ferracone says the rule has been negatively perceived by investors, who do not see the benefit of such disclosure. The ratio can be misleading, she adds.

She does not expect the rule to modify compensation policies significantly. "The thing that compensation committees fear most is losing a good executive. If they consider the retention of that executive to be at risk, that is what drives pay," Ferracone says.

Lin points out that gathering the data to establish the median compensation is going to be time-consuming and costly, especially for companies with large workforces and employees outside the U.S. Workforce structure will also be important, such as whether the company has its own employees or relies on contractors or franchisees whose employees would not be counted. "The optics of this rule will be significant for companies," Lin notes.

"The thing that compensation committees fear most is losing a good executive. If they consider the retention of that executive to be at risk, that is what drives pay."
—Robin Ferracone, CEO, Farient Advisors

Socially responsible investors and some pension funds are likely to pay attention to this ratio, but the chief concern is whether it will be used as a weapon by disgruntled employees, Hermsen says. He adds that unions—which are often shareholders—could use it in other contexts, as could politicians.

One outcome of these new rules is likely to be a burst of creativity in the presentation of the information in proxy statements and an explosion in the length of proxy statements, annual reports and other documents as companies try to explain the factors taken into account in their compensation policies. Happy reading. ●