Director Notes

Governance in the Dodd-Frank Act

Pay vs. Performance Disclosure: The Case for Prompt Attention

by Arthur H. Kohn and Janet L. Fisher

Even though the Dodd-Frank Act requirement on pay versus performance disclosure will not become effective for several months, the subject is expected to take center stage in the upcoming proxy season as universal say-on-pay votes force companies to address an issue at the core of the executive compensation controversy. The risks entailed in silence on the pay-for-performance equation may be amplified if peer companies generally address the point. This report discusses the issues on which board members should promptly focus their attention.

The Wall Street Reform and Consumer Protection Act of 2010 (also known as the "Dodd-Frank Act") includes several requirements that apply to U.S. public companies generally, and not just financial institutions. One of these is a requirement to disclose "pay versus performance" information in the annual proxy statement.[1]

The new disclosure could present an interesting perspective on a company's compensation system that builds on other information already included in the Compensation Disclosure & Analysis requirement (CD&A), and reflects the significant evolution in executive pay practices of recent years (see "Background," p. 2).[2]

[1] See Section 953(a) of The Wall Street Reform and Consumer Protection Act of 2010 (also known as the "Dodd-Frank Act," available at www.opencongress.org/bill/111-h4173/text/).

[2] On the Compensation Disclosure & Analysis section of proxy statements, see Matteo Tonello, *Corporate Governance Handbook: Legal Standards and Board Practices*, *Third Edition*, The Conference Board, Research Report 1450-09-RR, p. 85.

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Background

Under Section 953(a) of the Dodd-Frank Act, the SEC must amend its executive compensation rules to require disclosure by each public company of "information that shows the relationship between executive compensation actually paid and . . . financial performance, taking into account" the company's stock price performance.

The new mandate brings to mind the old requirement that companies include in their proxy statements, alongside their compensation disclosure, a graph showing stock price performance over the prior five years. Though still required for a company's annual report to shareholders, the graph was eliminated for proxy statements in 2006 in large part because the information was not thought to be illuminating.[a]

The stock graph was clearly not scrapped because the correlation of pay and performance became a moot issue. That topic is arguably the focus of the most intense interest and debate among companies and their shareholders, not to mention those commentators generally who are critics of executive pay.[b] Rather, the SEC recognized that the way the graph sought to address the topic was too limited to be helpful.[c]

When it was enacted, the expectation of the CD&A requirement was that the analysis would demonstrate how pay related to a company's performance, and many companies have focused increasingly on how the business environment and performance affect compensation, particularly in the wake of the recent financial crisis. However, the disclosure requirements do not specifically address the pay versus performance point that the stock graph was intended to capture. While they call for a detailed breakdown of compensation paid or awarded and an analysis of compensation committee decisions, they do not require an assessment of whether, looking back, the committee's decisions resulted in payouts correlated to performance over time.

For these reasons, if thoughtfully implemented, the new transparency requirement on pay versus performance could elicit informative disclosure that advances the SEC's original objectives in introducing the CD&A requirement in 2006. If implemented poorly, it could lead to unintended and adverse changes to executive pay practices.

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[a] See SEC Release No. 33-8765; 34-55009 (December 22, 2006), available at www.sec.gov/rules/final/2006/33-8765.pdf, amending the final rules adopted in SEC Release No. 33-8732; 34-54302; IC-27444 (August 11, 2006), available at www.sec.gov/rules/final/2006/33-8732.pdf.

[b] For all, see Lucian Bebchuk and Jesse Fried, *Pay Without Performance: The Unfulfilled Promise of Executive Compensation* (Cambridge, Massachusetts: Harvard University Press), 2004.

[c] The U.S. Congress has been somewhat inconsistent on the issue of "pay for performance." It recently eliminated the performance-based compensation exception under Section 162(m) of the Internal Revenue Code for health insurers and financial institutions that participated in the government's TARP program, thereby removing an incentive for companies to utilize performance-based pay arrangements.

These practices have included more widespread use by public companies of a range of metrics tied to company and individual performance and a trend towards cash and equity incentives with longer term payout periods to mitigate business risk and "short-termism" in executive focus (see "The Conference Board on the Pay-for-Performance Debate," p. 6).

Based on the published timetable for rulemakings under the Act, implementing rules for this provision will be proposed in April 2011 at the earliest, which gives the SEC ample time to consider the complex questions this general topic raises.[3] This report discusses the reasons why companies should nonetheless promptly focus on the implications of the new requirement.

Clearly delineated in the Dodd-Frank Act, the pay versus performance issue will attract renewed and increased attention from investors and commentators. Even though this element of the Dodd-Frank Act will not be in place for the next proxy season, universal "say-on-pay" votes will take place for the first time, forcing companies to be even more forthcoming about their compensation policies.[4] Companies that can provide a succinct, coherent, and persuasive picture about the correlation of pay and performance—notwithstanding in many cases the absolute performance of their stock price—are advised to do so, perhaps as part of the CD&A. If met by silence on the issue, the risks may be amplified if peer companies generally take measures to address the point in their proxy statements.

Supplemental disclosure Once rules are adopted, many companies will likely want to consider supplemental information to accompany the required disclosure. As discussed in this report, the possibilities for supplemental disclosure are varied, and in some cases require relatively complicated and sophisticated analysis. The disclosure will be of paramount importance for senior management and compensation committees for obvious reasons, and should not be at odds with the company's other communications about performance. Drafting the disclosure will therefore require considerable attention, particularly where executive pay and company performance may not have been closely correlated previously. Companies should begin to consider the factors behind the relative degree of historical correlation—information that could also inform the compensation committee's deliberations about executive pay for the coming year.

Needless to say, the risks arising from regulatory rules that are not well thought out are considerable. Overly prescriptive rules could result in disclosure indicating a lack of correlation between pay and performance when the correlation is close, or vice versa.

One example involves the method that is required to be used in allocating compensation to particular periods. An equity award made today may reflect the good performance of last year. It may be subject to time-based vesting as a retention incentive. If the rules require that it be treated as compensation when it vests, and vesting occurs when the market generally is up due to a favorable investment outlook, even though company performance is down, the picture conveyed by the pay versus performance disclosure would be distorted. In that case, a company might be inclined to avoid that result by eliminating the vesting requirement.

Participating in the SEC comment process

Thinking through pay versus performance disclosure issues in advance of the issuance of the SEC's proposed rules will also position companies to provide more useful and detailed comments and an opportunity to influence the final framework for the disclosure. Given the sensitive nature of the topic and the potential for disclosure that is both uninformative and costly to prepare, companies should have a strong interest in commenting on the rule proposal.

[3] SEC Chairman Mary L. Schapiro, "Testimony Before the United States Senate Committee on Banking, Housing, and Urban Affairs on Implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act by the U.S. Securities and Exchange Commission," September 30, 2010, available at www.sec.gov/news/testimony/2010/ts093010mls.htm.

[4] See Section 951 of the Dodd-Frank Act. For the recently proposed SEC rules on say on pay, see SEC Release 33-9153; 34-63124 ("Shareholder Approval of Executive Compensation and Golden Parachute Compensation,") October 18, 2010, available at www.sec.gov/rules/proposed/2010/33-9153.pdf.

Many commentators have noted the ambiguities in the Dodd-Frank requirement and the significant technical issues it raises. Key among them are an absence of guidance about the period over which performance is to be measured, when and which executives' pay is required to be taken into account, and how to measure their performance. The SEC is expected to address these ambiguities. For the reasons discussed in this report, a strong case can be made that the SEC's approach should provide companies with significant flexibility to design meaningful disclosure.

In any case, past SEC guidance indicates that, even if the SEC requires a specific performance metric or other disclosures, companies may provide supplemental disclosure tailored to their circumstances.

Aside from addressing these ambiguities, there are numerous approaches and methodological issues that a company might consider:

Performance assessment For example, should a company assess and disclose the degree to which its executive pay levels were sensitive to its performance in absolute terms or relative to its peers? The answer might depend, among other aspects, on its business circumstances. A company in a difficult competitive position and in need of new executive talent might find itself having to pay more than its peers to attract talent. That context would provide a more constructive framework than an absolute presentation for shareholders to evaluate the company's pay practices.

Risk-mitigating factors Similarly, a company could consider the extent to which risk-mitigating features of its pay program affect the sensitivity of executive pay relative to its performance. Should information about the degree of change in executive pay relative to performance be presented separately for periods of relative outperformance and relative underperformance or should the information for all periods be combined? Should a single period be shown or should multiple periods be shown reflecting business cyclicality, significant changes in the competitive landscape, or changes in the composition of the executive team or compensation committee?

Illustrative considerations With respect to these issues, it is possible to identify many types of business and other considerations that could materially affect the approach to be taken in response to the new requirement. This report describes a few of them, however it is likely that companies will think of many others as they begin to assess the application of the new disclosure requirement to their specific circumstances.

Lean management Arguably, pay versus performance assessments should take into account how much "bang for the buck" a company gets from its total management team. For example: assume two companies have performed equally well and their five most highly paid executives have earned the same compensation. Now assume further that one of the companies has a senior management team that is twice as large as the other. It would seem that the company with leaner management should provide pay versus performance disclosure that tells that story by looking at the issue on a relative basis and including more than just named executive officers in its analysis. Precise data to support this approach might be difficult to obtain, but it may not preclude the company from making the point.

Cyclical businesses As suggested above, companies in classically cyclical industries (e.g., retail, construction) should consider presenting data in a manner that reflects that business reality. Possible approaches could include presenting data using multiple periods or measuring performance based on the extent to which the variation in profitability was mitigated through the entirety of the cycle.

Crisis management A disclosure approach that fails to distinguish performance in ordinary business environments from performance during short-term crisis periods will often not provide meaningful information. During the recent financial crisis, for example, the performance goals that underlie most incentive programs were set aside as many companies focused on steps needed to manage through the crisis. In addition, not surprisingly, management turnover increased, particularly at financial institutions. In order to present useful information on pay versus performance, those factors should be taken into account.

Business organization and the identity of the NEOs Between one and three of a company's executive officers named in a disclosure will typically have divisional responsibilities, while the CEO, CFO, and one or two other NEOs will have corporate-wide responsibility. Different divisions could have very different performance profiles. Often, using only corporate-wide performance metrics—or a crude "lumping together" of divisional metrics—to assess the relationship of pay to performance will be uninformative and unreflective of the actual correlation between pay and performance. Similarly, aggregating the pay of the entire executive team may mask significant interesting information about the relationship of pay to performance.

Allocating pay to performance periods There are both obvious and subtle challenges in deciding how to best allocate pay to specific performance. For example, should an option be considered "actually paid"—i.e., taken into account in the pay for performance analysis—at the time it is granted or exercised, or at some other time? Should it matter whether the number of options awarded is fixed by contract or practice in relation to base salary levels, or instead varies from year to year based on individual performance assessments?

The need to attract Should elements of compensation that are explicitly not intended to reflect performance be included in the analysis? In many industries, companies must pay signing bonuses or other guaranteed minimum payment elements to attract employees. Is it appropriate for those elements of compensation to be excluded from the pay for performance presentation on the basis that the compensation committee's incentive pay decisions should not be obscured by pay elements that are not intended to be performance driven?

Risk, diversity and other intangibles As suggested, the correlation of pay to performance may be affected by aspects of compensation plan design whose purpose is to mitigate risk. Similarly, other "intangibles," such as diversity or relative pay levels between senior management and rank-and-file employees, may be taken into account in assessing pay for performance. Can and should these factors be considered?

The practical complexity of applying the new requirement suggests that the most meaningful approach will vary by company. It also suggests that stock price, while relevant, ought not to be the exclusive means of measuring performance, despite its obvious importance to shareholders. While the direction provided by the statute is not especially helpful in recognizing these complexities, it appears to provide room for the SEC to fashion rules that will lead to coherent and useful disclosure.

The Conference Board on the Pay-for-Performance Debate

Boards of directors set the compensation of senior executive officers. In performing their duties, directors should be mindful of their responsibility to create sustainable, long-term wealth for all shareholders. It means designing compensation arrangements suitable to:

1. attract and retain key talent in a competitive marketplace;
2. motivate managers in the pursuit of long-term goals; and
3. reward managers financially based on their actual performance.

In particular, issues of pay for performance have been drawing attention in shareholder meetings and—due to an increased public sensitivity to the apparent causes of the most recent financial turmoil and the compensation rules included in the Dodd-Frank Act (from say-on-pay to pay versus performance disclosure)—are expected to take center stage in the upcoming proxy seasons.

The Conference Board recommends that compensation committees review their companies' compensation policy to reinforce, where necessary, the notion that compensation reflects performance; as well as introduce forms of accountability for any risk-taking that is unjustified based on the approved long-term business strategy. However, the board's ultimate responsibility is to weigh principles of pay for performance against the need to participate effectively in the market for human capital. In particular, compensation programs should be designed to address:

- How to establish a strong link between the variable portions of total compensation and the economic objectives of the corporation. Motivational drivers, managerial culture, and behavioral incentives should be central topics of discussion. Committee members should fully understand the effects of each single component of the pay package (i.e., base, bonuses, equity-based incentives, benefits and perquisites, deferred compensation, and severance) on the whole compensation arrangements and be persuaded that:
  1. the balance between the base salary and the other components is appropriate; and
  2. the intended effects of the variable components cannot be distorted by managers to pursue opportunistic behaviors.
- How to measure corporate performance to ensure that it is properly rewarded and that assessment periods are long enough to determine whether management decisions were, in fact, successful in creating sustainable shareholder value. Depending on the business strategy and the key performance objectives on which the company should focus, in designing the compensation policy, the board should consider a wide array of financial and extra-financial performance metrics and targets. Financial metrics may include operating cash flow (OCF), cash-flow return on investment (CFROI), and other measures of economic value added. Nonfinancial or operational metrics include compliance standards, product quality improvements, customer satisfaction data, and other reputation measures. A more diversified set of metrics would stimulate management to deploy all of the company's assets (including valuable intangible assets) in the pursuit of its strategic goals.
- Annual performance evaluations. The compensation committee should plan on using the selected metrics during the annual performance evaluation of each executive. To avoid possible distortions to the evaluation process, the committee should guard against using financial metrics that are heavily dependent on the chosen method of accounting or that lend themselves to other types of machinations. Experience shows that, in most circumstances, CFROI and OCF are preferable to traditional metrics, such as return on equity (ROE) and earnings per share (EPS), which can be affected by revenue and expense recognition or manipulated through stock buybacks at the end of the period.

Conference Board on the Pay-for-Performance Debate (cont'd)

- Ways to disclose performance targets. The compensation committee should also discuss disclosing performance targets to shareholders, especially if such targets are necessary to understand the material terms of the company's compensation program. However, directors should be sensitive to the potential loss of competitive advantage value that may result from disclosure and therefore weigh transparency levels against strategic needs.
- What tools should be used to avoid the distortions and pitfalls of certain equity-based incentive programs. Companies should consider moving away from traditional stock options that vest based on continued service, since they are proven to encourage an excessive focus on short-term stock price results to the detriment of long-term, sustainable business goals. Other solutions include:

1. adopting stock retention policies (or post-vesting holding periods), including possibly the requirement for top executives to hold a substantial portion of equity after ending their service for the company and until their retirement;
2. granting restricted stock (which is forfeited unless "earned out" over a stipulated period of continued employment); and
3. designing stock option plans in which the options vest only upon meeting certain long-term performance goals uncorrelated to the current stock price.

(The compensation committee should consider adopting and motivating formal guidelines on incentive-based compensation for disclosure to shareholders.)

- The overall fairness of any compensation grant, including benefits and perquisites (e.g., housing and relocation allowances, use of corporate jets or limousines, etc.). To examine this aspect, the committee may develop internal analytical tools, such as wealth accumulation analyses and studies on the correlation between top executive compensation and the salary levels of other employees. Specifically, wealth analyses may prove useful in determining the need for severance and retirement benefits, whereas equity indicators help ensure that resources are not gravitating to the top thereby creating a retention—and possibly a succession—problem. The compensation committee should also report on compensation fairness to the full board so that all directors have an understanding of the magnitude of total potential payouts to executives, particularly to the CEO, in such unique or unusual circumstances as an extreme increase or drop in the company's share price or in the event of a merger, acquisition, or going-private transaction.

Sources: The Conference Board Task Force on Executive Compensation Report, The Conference Board, 2009, Principle 1, page 12; Matteo Tonello, *The Role of the Board in Turbulent Times: Leading the Public Company to Full Recovery*, The Conference Board, Research Report No. 1452, 2009, p. 13.

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