Pay Versus Performance Disclosure

The Dodd-Frank Wall Street Reform and Consumer Protection 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. Based on its 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. Thoughtfully implemented, the requirement could elicit informative disclosure that advances the SEC's original objectives in introducing the Compensation Discussion & Analysis, or CD&A, requirement in 2006. Implemented poorly, it could lead to unintended and adverse changes to executive pay practices.

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.

The stock graph was clearly not eliminated 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 who are critics of executive pay more generally. Rather, the SEC recognized that the way the graph sought to address the topic was too limited to be helpful.[1]

[1] 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.

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The expectation of the new 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. The disclosure requirements do not, however, 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.

The Dodd-Frank requirement could thus present an interesting perspective on a company's pay practices that builds on other information in the CD&A and reflects the significant evolution in executive pay practices in recent years. 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 pay-out periods to mitigate business risk and "short-termism" in executive focus.

The Case for Prompt Attention

There are good reasons for companies to focus promptly on the new pay versus performance disclosure requirement.

Now clearly surfaced 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 2011 proxy season, universal "say on pay" votes will be required. 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 well-advised to do so, perhaps as part of the CD&A. The risks entailed by silence on the issue may be amplified if peer companies generally do take measures to address the point in their proxy statements.

Once rules are adopted, many companies will likely want to consider supplemental information to accompany the required disclosure. As discussed below, the possibilities for supplemental disclosure are varied, and in some cases require a 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. 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.

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 illustration involves the method required to be used in allocating compensation to particular periods. An equity award made today may reflect good performance 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.

Opportunity to Influence the Requirement 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.

Many commentators have noted the ambiguities in the Dodd-Frank requirement and the significant technical issues it raises. Key among these is an absence of guidance about the period over which performance is to be measured, when pay is required to be taken into account, which executives' pay is required to be taken into account, and how to measure performance. We expect that the SEC will address these ambiguities. For the reasons discussed below, 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 the ambiguities noted above, there are numerous approaches and methodological issues that a company might consider. 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, for example, 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.

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 out-performance and relative under-performance, 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 of the compensation committee?

Illustrative Considerations

In considering these issues, we readily identified many types of business and other considerations that could materially affect the approach to be taken in response to the new requirement. We describe a few of them below. We suspect that companies will identify many others as they begin to consider how the new requirement could apply to them.

- ***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. That is, assume two companies that have performed equally well and in which the 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 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 the named executive officers for a company 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 above, 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?

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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. This latitude could be a boon if the SEC capitalizes on the opportunity it offers to avoid an unnecessarily prescriptive framework.

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