

New Red Flags for Executive Pay

By Joseph R. Rich

The SEC's expanded reporting standards for the coming proxy season require a fundamental rethinking of the process and rationale underlying companies' executive pay programs – from the collection of data and adoption of program principles through plan development, discussion and formal adoption.

It is essential that Boards begin *now* to identify and address what are likely to be the new “red flags” of expanded disclosure for investors and the media, who are increasingly focused on the structure and level of executive compensation programs:

1. It's really 2007. Although companies are not yet subject to the revised rules, Boards must keep in mind that everything done in connection with 2006 pay programs will be fully reportable under the new standards that will be effective for 2007 proxies.

2. It's all about process. The SEC intends not only to improve the reporting of executive paychecks, but also to publicly explicate the *process* by which compensation decisions were reached. Essentially, a process issue will be anything that has a “how” in it – how peer companies are chosen, how the role of consultants and management in pay decisions is decided, how the mix of pay is decided, and how company and individual performance are factored into pay decisions. In my experience, that's something many companies have not considered in sufficient depth, even though they do internally understand the reasons behind decisions.

3. Minutes will save you days. New proxy disclosure requirements for the Compensation Disclosure and Analysis, which will be treated as a filed document subject to certification under Sarbanes-Oxley, include a description of the Board's processes. Many committees currently are in the habit of formally recording the outcome, but not the process, of their decisions. Given the difficulty of trying to reconstruct that process after the fact, committees should begin now to keep thorough minutes that can serve as the basis for putting the CD&A together.

4. Write your story before you have to read it. In this case, the writing *is* the CD&A. Writing crisps the thought process and highlights the direction being taken, putting service providers and/or internal management on notice that the committee is serious about getting it right. That's more difficult than it looks, because members naturally rely on a lot of institutional knowledge in making decisions. They know the company, its executives, goals and culture, and tailor compensation appropriately and effectively to address that unique situation. Under the new rules, though, the



investor community must be brought up to speed on that kind of internalized operational knowledge— their “autopilot” considerations.

5. Disclosure is guidance. Undercover police officers can spend hours talking about “tells” – inadvertent, subconscious actions that indicate what a suspect is thinking or doing. The proposed disclosure rules have similar tip-offs. Some are more obvious – how incentives are structured is a big “tell” that signals to investors what the committee considers the company’s priorities and goals. More subtle “tells” are imbedded in the assumptions associated with certain disclosures. For instance, the age assumptions used in valuing CEOs’ retirement benefits points to the committee’s expectations regarding their retirement. Similarly, the assumptions used in valuing an executive’s potential Change in Control arrangements can point to whether the Board anticipates a deal sooner or later, depending on whether the share price used is lower or higher than the current price.

6. Disclosure requires closure. It may be an apocryphal tale, but when Babe Ruth stood at home plate and pointed his bat at the lower right field seats, he was telling fans the next pitch would be hit right there out of the park. If the Babe hadn’t hit it out, would he have had to explain why? What explanation is needed from the committee if management hits a triple rather than a home run, but members still want to reward executives for doing very well? New disclosure rules will likely require committees to outline how and why they decided to pay what and to whom, including an explanation of how company performance factored in. My recommendation is that members write what they want to read in 2007, but also consider what the best way will be to disclose a miss, however slight, and the committee’s desire or need to pay.

7. Expanded disclosure means the weather, not just the news. Going forward, a big part of disclosure in addition to reporting pay in the previous year will be a forecast of executive compensation under future scenarios such as termination, retirement and Change-in-control. Boards can be sure that when media pundits and investors weigh in on 2007 proxy statements, they will zero in on disclosure of potential future compensation, particularly separation arrangements. Those now will be the really big “Holy Cow” numbers. Compensation committee should be thinking now about how they will respond when the press inevitably questions those disclosures.

8. Don’t pay a dollar for a dime. New disclosure rules will make more visible to shareholders a significant inefficiency in many current Change-in-Control arrangements for executives. One tendency of Section 280G is to make executives who face a potentially significant haircut to their long term earnings more reluctant to support a sale of the company or identify buyer candidates. Strategies to mitigate this tax disincentive, such as 280G gross-ups, were developed to deliver a small amount of additional after-tax compensation to the executive. But they also entail substantial tax-related payments and lost tax deductibility for the company. In some



cases, the efficiency of 280G gross-ups can be 10% or less, meaning that for every dollar the firm pays, the executive could get \$0.10 or less in benefit. That significant cost will be fully revealed to investors for the first time.

9. It's a table, not a stool. For years, most organizations have viewed compensation as consisting of base, bonus, and long term incentives – the classic “three legs” of the compensation stool. But the new disclosure rules will highlight that there is now significantly more to compensation. Post-separation compensation is and will become much more visible as a major component of the total compensation package – the fourth leg of the pay table.

10. Don't be a slave to the data. Boards must recognize that the executive talent market is not Wal-Mart, but Sotheby's – a place in which value to the beholder is more important than price alone. Companies traditionally have measured compensation data with too fine a tolerance, relying on market data without a broader market perspective. A particular executive's work and performance also should be assessed relative to the company, environment, team and how he or she fits in – essentially, the level and form of compensation needed to attract, retain, and motivate an executive *in a particular situation*. For example, it may be most appropriate to pay a long-term, highly effective chief executive in the 75th percentile. Paying another executive 8% less than the market median does not necessarily render him or her a flight risk, nor will offering an incentive that is less than 100% of base automatically make that executive less motivated.