

# As We See It

## Will More Disclosure Mean Lower Pay?

Nature abhors a vacuum, and when it comes to their own compensation, so do most executives. That's why the SEC's proposed disclosure rules, driven by the assumption that making more data available about executive compensation will rein in pay levels, are more likely to result in many companies simply rearranging the geography of existing compensation. **As we see it**, "how" executives get paid will change – but not necessarily how much.

Like motherhood and apple pie, it's hard to find fault with the very democratic notion of giving shareholders more information about how the people responsible for running America's public companies are paid. Despite much lip service to the principle of "pay-for-performance", at present companies are not required – and few volunteer – to explain in detail how their compensation incentives are aligned with shareholders' interests. Supporters maintain that public access to detailed data in "plain English" would empower shareholders to push for better pay programs, force Boards of Directors to display more backbone and shame overpaid executives into toning down their demands.

The proposed new SEC regulations would go a long way toward clarifying the true cost and the rationale behind highly complex, multi-faceted executive pay programs. Along with requiring companies to provide a more standardized valuation of stock and stock option awards, the SEC rules would drag from the shadows what can be highly lucrative arrangements that currently fly under shareholders' radar. These include the value of retirement plans and non-qualified deferred compensation programs; perquisites in excess of \$10,000; and contractual guarantees related to a termination or change-in-control. Also popular with advocates of pay reform is a proposal that companies annually provide a single, definitive, bottom line figure that encompasses the total cost of all executive compensation arrangements.

We support efforts aimed at greater transparency, but with realistic expectations of the impact more mandates

will have on pay programs. Past experience with regulatory intervention demonstrates that disclosure in and of itself not only won't keep executive pay in check, it may make things worse. The reason? Disclosure provides marketplace information on compensation at the top of the corporate ladder that is of keen interest not only to investors and the media, but also to executives eager to compare their paychecks with those of their peers in other corner offices. More disclosure enables managers and their advisors to more easily analyze competitors' programs on a dollar-for-dollar basis.

Historically, when executives discover a gap in their pay packages, their reaction is to want it filled – and fast. Too often Boards, whether concerned about remaining competitive in the marketplace for top talent or figuring their own leader deserves the best, have readily concurred. As a consequence, average CEO pay levels have steadily ratcheted up, while the most egregiously overpaid executives have ended up looking somewhat less so. The power of CEOs' desire to keep up with the Joneses was most clearly demonstrated when Congress imposed limits in 1993 on the tax deductibility of non-performance-based compensation over \$1 million. Rather than dampening pay levels, a salary approaching seven figures soon became the norm among large companies.

Similarly, the preservation of good optics may trump meaningful change in compensation programs. Newly identified "lightning rods" such as executives' use of corporate aircraft and corporate payment of their country

club fees will need to be more clearly reported under the new rules. Such controversial benefits will decline in use, but their value in many cases will simply be shifted to more politically acceptable areas such as performance-based equity awards in order to keep executives whole.

Ironically, more disclosure mandates may have a chilling effect on real transparency. We applaud the SEC's proposal for a Compensation Discussion & Analysis report, a filed document that would correlate to the mandatory Management's Discussion and Analysis of Financial Condition and Results of Operations. However, given corporate lawyers' tendency to correlate filings with liability, there is potential for many companies to seek out "proven" disclosure language that meets minimal requirements, but does nothing to advance real candor or understanding of executive pay decision-making. The kind of Compensation Committee Report "boilerplate" decried by the SEC could end up being replaced with a new brand of boilerplate.

The SEC's proposal that companies provide a single definitive number for the total cost of CEO pay is politically appealing, but simplistic. The use of tally sheets to assess compensation has proven invaluable to Boards seeking a means to track the fluctuating value of various pay elements. But tally sheets are only a tool, and a limited one at that. It's ultimately deceptive to slap an absolute annual value on CEO pay, given that the value of an executive compensation package at any given moment in time varies widely, depending on performance and other variables. Which of many potential scenarios should a company choose to calculate a definitive proxy pay total? And how can investors equitably compare that number to CEO pay at other companies?

The bottom line: the current level of information provided to the public about executive pay is inadequate and unclear and there is a pressing need to bring into better focus the structure and rationale underlying compensation programs, not simply a total price tag. Heightened disclosure rules ideally will serve as a catalyst to Boards and investors to view executive compensation programs more closely and holistically. That means analyzing all elements of pay relative to their risks, rewards and potential to deliver real value to the shareholder.

Ideally, the marketplace will keep Boards' feet to the

fire by consistently rewarding companies which abide by and explain their pay-for-performance philosophy, and devaluing those that persist in poor program design or meaningless disclosure. In such a scenario, even if overall executive pay levels do not decline significantly, the SEC has taken a major step toward making pay programs more equitable and truly performance-based.