

The Outlook for Executive Compensation Disclosure By Donald Delves



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Public outrage of excessive executive compensation at companies that have experienced big failures is driving Congress to consider legislating areas of compensation for firms that receive funds from the government's Troubled Assets Relief Program. But, it's worthy for all companies to keep an eye on developments, for such actions often have a tendency to trickle down.

There has been more public talk about compensation in the last several months than in the past 30 years. Amid public outrage over executives receiving substantial bonuses for failure, the government has churned up a tsunami of proposed legislation and regulation.

Of course, many of the initiatives won't make it through the Washington sieve. So companies can disregard the less likely among them, along with the attendant political rhetoric and regulatory actions that would apply only to companies receiving Troubled Asset Relief Program money.

By applying their own screens, companies can get a handle on what changes may be coming their way and prepare for potential impacts. Here's a rundown on the areas of initiatives that are most likely to become reality:

Say on Pay. This is shorthand for a mandatory requirement for a nonbinding shareholder vote on executive compensation plans. Already a reality for bailed-out banks, this requirement may soon apply to all public corporations of any size – if Treasury Secretary Timothy Geithner and others have their way – and possibly in time for next year's proxy season.

Countries in the United Kingdom have had this requirement in place for several years, and boards there take it quite seriously. In anticipation of a shareholder vote, these boards take time to engage in dialogue with major shareholders to vet prospective changes, testing the waters before advancing full-fledged proposals.

Say on pay would spur U.S. boards to do a better job of engagement and disclosure. This means clear communication in simple language so that all shareholders can grasp the message. Even though the U.S. Securities and Exchange Commission has adopted a "plain English" requirement for proxy statements, companies will have to make things even plainer to effectively communicate compensation changes. This means getting investor relations and public relations people involved in preparing proxy statements.

Compensation Consultants. The SEC currently requires compensation committees to identify their consultants. The commission is expected to take this a step further by requiring disclosure of information about companies' relationships with its consultants, including how much they are paying the consultants. Companies will probably also have to disclose, for example, whether these consultants do other work for the company – that is, whether they or their firm handles benefits administration consulting, because this ultimately falls under the purview of the CEO on whose pay the consultant is advising the board.

This requirement would prompt companies to take a close look at how much they're paying for advice and to evaluate its quality, including the degree of independence. This doesn't mean that companies who use their executive-pay consultant for other work should necessarily hire a separate consultant from those advising management; they may very well be receiving high-quality, objective advice.

Risk. Eventually, the federal government will require in proxy statements a discussion of the degree to which compensation programs induce executives to take risks. Among the items on the legislative/regulatory table, this may be the most critical for corporate financial executives to wrap their minds around.

Disclosure of risk assessments is among the principals that Geithner is encouraging the SEC to include in new regulations. Boards' compensation committees would be required to show shareholders their due diligence in weighing corporate financial risk-versus-return issues in designing the incentive-pay structures of top executives.

A regulatory focus on risk would force a shift in compensation-planning gestalts. The emphasis on the dynamics of executive compensation plans has always been two dimensional: pay and performance. The third dimension of risk has always received scant attention relative to its importance – until now.

Naturally, it's important to assure that compensation structures motivate executives to take risk. After all, that's why they call this part of their pay "at-risk compensation." Because of it, executives take appropriate risks they might otherwise not take. Yet, if incentive-pay targets are ill-conceived, they can result in excessive risk to the company. For example, excessive use of stock options can induce management to take on excessive debt, reduce or eliminate dividends and focus too much on short-term results.

Disclosure of risk considerations would prompt deeper deliberations on how much risk and reward should be built into plans relative to the maximum amount of risk that directors want management to take.

Boards that already engage in thoughtful analysis on the subject and voluntarily disclose it would be getting out in front of eventual requirements and would garner governance kudos.

Golden Parachutes. Geithner is pushing for requiring a nonbinding shareholder vote on "golden parachute" benefit packages, which are triggered by a change in control. Some companies have recently reduced their golden-parachute benefit multiples from three times salary and annual bonus (along with acceleration of options and restricted shares) to two times or even 1.5 times. The logic is that most senior executives don't take three years to find their next job. Amid this emerging trend, the three-times multiple is increasingly being viewed as providing as an insidious incentive because it can motivate executives to take actions resulting in a change-of-control out of self interest, and not shareholder interest.

The purpose of the parachute is to give executives incentive to maximize the value of the new compensation and sale price, keep them in place through the transition and protect them in the event of termination by the new management team. A required vote on parachute benefits would compel boards to re-examine contract provisions to ensure that they are fair to executives – and hence, will help them attract, retain and motivate talent – but also that they are aligned with shareholder interests.

Clawbacks. Though somewhat less likely than the provisions outlined above, there is a good chance that clawback provisions of executives' employment agreements could receive some regulatory emphasis.

Currently, most companies use clawbacks requiring executives to return incentive pay, but only in extreme instances involving fraud or malfeasance.

Not surprisingly, precious few payments to executives have ever actually been returned. Increased regulatory emphasis would put pressure on boards to put more teeth in clawbacks, however, calling for bonuses to be returned in the case of inaccurate or misstated financial results. Again, companies that do so voluntarily and then tell the world about it would get the benefit of positive optics.

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