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Comments on Proposed Changes to Proxy Disclosure of Executive Pay

The SEC is poised to make some of the most significant gains in its 60+ year quest to ensure shareholders receive critical executive pay data from US corporations. Investors deserve to know not only how much pay is earned, but what level of performance triggers these payments. Clear and consistent guidelines for proxy reporting will increase the accountability of management and the board, while potentially reducing the cost to comply if common sense rather than stochastic valuation models are used.

Three changes would enable the proposal to fulfill its landmark mission establishing clear "plain English" communications among management, boards, and investors:

1) Divide tabular reporting into two categories, with the Summary Compensation Table reporting management's actual pay to-date, Supplemental Tables detailing new grants.

2) Use a simple, common-sense forecast to report equity-based pay opportunities.

3) Provide detailed criteria used to determine incentive opportunities and awards, stripping the cloak of secrecy often used by many companies.

These changes to the proposal could make the proxy statement as useful as the annual report as a basis for informed investment decisions.

Tabular Reporting

The total compensation figure is vital. Shareholders have long wanted it, while many executives question its utility. Board members are wary of providing the press figures that may be used to highlight corporate greed. As an amalgamation of past, present and future pay elements, the proposed Summary Table total compensation figure serves the sensationalist press therefore justifying board concerns and executives' criticism. The possibility for an unrealistic total, acknowledged in the draft's comments, can be avoided by using the Summary Table to report compensation as it is earned, and the Supplemental Tables to report potential values of current grants.

- The Summary Table should be reserved for amounts paid (and/or earned) during the reporting period. Amounts increasing executives' net worth should be reported for each of three years, including:
    - salary,
    - short or long-term performance bonuses ,
    - the annualized portion of time-restricted awards,
    - the value of benefits and perquisites for each year,

    - gains from the exercise of stock options -- the premium of the market value of shares above the exercise price,
    - total compensation – the sum of these elements

  - Supplemental Tables should deal with grants of future pay opportunities

The Summary Table should provide the context of executive pay against which the compensation committee approves grants as summarized in the Supplemental Tables, with details and rationale in the narrative. The resulting total compensation numbers would be more tangible than what is currently proposed, closely resembling W-2 values. In fact, why not have W-2 numbers as generated by the company included as a reality check?

Valuing Equity Awards

The two proposed Supplemental Tables are fine in concept. The table reporting performance-based incentives must disclose any share-price appreciation used in establishing the values of grants. There should also be a detailed narrative explanation of both the rationale for the magnitude of a grant, as well as the performance criteria used to determine the eventual award value.

The challenge is the table reporting the value of share-based incentives. Any estimate of values granted belongs in the Supplemental Tables, not in the Summary Table which should report actual amounts earned (e.g., options exercised, not options granted). The method used to report equity plan values should reflect the compensation committee's thinking as they approved the grant.

The apparent criteria for proxy disclosure include consistency, completeness, and clarity. Fair market value models used under FAS 123R do not meet these criteria, as

  - The specific method to calculate value is left to each company,
  - Factors such as vesting are irrelevant for individual awards,
  - Neither the binomial nor Black Scholes models is "plain English", nor is either applicable to executive stock options which typically have exercise periods measured in years, not a date certain as with traded options.

The FAS 123R approach may be useful to determine the overall costs of grants, but is inappropriate for individual awards. As exotic costing models are seldom used to determine executive awards when made, why use them to report the value of awards?

The compensation committee should report the values they believe they are conveying, with the assumptions and rationale underlying each assumption. What share price appreciation did they assume when making the grant? For example, "We believe these options would be worth $1 million, if shares appreciate by the 10% annual rate in our mid-term plan, the executive holds them for 5 years, the average time options are held in the US, and the resulting value is discounted to today's value by the cash discount rate."

The committee can then be held publicly accountable for its decisions. Investors can decide whether management is being held to reasonable performance criteria, given the magnitude of grants being made against a background of historic pay and performance. Moreover, they can better understand the value of awards without sophisticated economic or statistical methods.

Disclosing Specific Criteria for Determining Awards

Why assess the value of an executive's pay opportunity when in a multi-billion dollar corporation such amounts may fall within the margin of rounding? Investors gain insight into executives' motivation through understanding how pay opportunities are determined. Are executives encouraged to behave as employees, partners or investment managers? This insight requires specific details of performance targets which are not likely to be universally available if the caveat that "companies would not be required to disclose any factor, criteria, or performance-related or other condition to payout or vesting of a particular award that involves confidential commercial or business disclosure of which would adversely affect the company's competitive position" is retained. This is an invitation for obfuscation.

Would a publicly traded company be able to effectively challenge full and consistent disclosure of performance targets? Would the courts hold that such a universal standard constitutes an unfair burden or put some companies at a competitive disadvantage? How can this standard be measured? Is it relevant to weigh the absolute quantum of pay without knowing how rigorous is the accompanying performance criterion? Competitive advantage lies in the methods used to achieve performance, not in defining goals.

Providers of debt often attach covenants requiring that certain performance levels be maintained. Shouldn't equity holders have the right to know what levels of performance trigger incentive awards? Those investing either equity or debt need to assess management's ability to achieve goals. This can only be done by stripping away layers of dissembling from companies who choose that route, and highlighting enlightened practices of companies electing a straightforward representation of goals and rewards.

Conclusion

The advantage for US shareholders investors is an enhanced ability to assess equity investment risks. For executives and boards, open and clear disclosure of executive pay practices may head off government, investment community or stock exchange initiatives prescribing or restricting compensation approaches, levels or vehicles. One need only look at the UK to see the effect when shareholder groups seek to dictate the tools companies can use. Dictating specific approaches such as dilution limits or performance factors or vesting terms stifles innovation, inhibits competition for global talent and potentially puts the design of pay into the wrong hands. Far better to hold management and the board to a straightforward reporting standard – tell us how much pay is being delivered and why.

Leslie Kelley, currently with Frank B. Manley & Company, spent ten years as an executive compensation consultant. He left to head NY-based EMI Music's compensation and benefits function for 10,000 employees in 60 countries. He went on to become the SVP Human Resources for EMI Music's London-based parent company, EMI Group plc. As the chief link among management, the remuneration committee and key shareholders, he gained extensive experience in designing and communicating executive compensation programs, monitoring and reporting corporate governance and managing the pay related aspects of shareholder relations. From that vantage point, as well as that of a private investor, he offers practical comments and suggestions to make the proposed approach to proxy reporting more effective for all parties.