THE SEC'S DISCLOSURE DILEMMA

What boards need to know about potential changes to compensation disclosure requirements.

WHEN THE SEC'S own chair describes compensation disclosure rules as a "Frankenstein patchwork," it's clear something has gone awry. In recent years, efforts to provide investors with a better understanding of compensation programs through more robust disclosure requirements have resulted in an ever-expanding slate of rules, from pay-versus-performance calculations to CEO pay ratios and clawback disclosures.

As a result, compliance moved beyond burdensome to outright bewildering for many companies, particularly those without deep internal resources. What's more, rather than painting a clear picture of how pay aligns with performance for investors, the resulting disclosures often missed the mark in telling a coherent, decision-useful story. Instead, new requirements, a short window of time to comply and lack of definitive guidance from the SEC resulted in overly complex CD&As presenting layers of repetitive, confusing or even, at times, contradictory data.

QUALITY OVER QUANTITY

The very fact that the SEC felt the need to host the event at which its chair, Paul Atkins, made that Frankenstein reference—a July roundtable discussion on executive compensation—was roundly viewed as an acknowledgement that the current disclosure framework had grown unwieldy. And the comments of SEC commissioners, investors, executives and advisors participating in the discussion itself underscored that sentiment. "My takeaway from the roundtable is that there seems to be a bit of pendulum shift away from what's been a very additive approach to the regulatory process in recent years," says Jose Furman, a principal at FW Cook. "At a minimum, it looks like this may lead to less regulation and more concise disclosure in an effort to improve investors' understanding of executive compensation."

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Relief in the form of revisions to current mandates also appears possible—perhaps even likely. "This was the first real sneak peek at what the SEC commissioners are discussing in terms of potential disclosure changes," says Michael Abromowitz, a principal at FW Cook, who sees the shift as reflective of a new, Republican-controlled commission's approach to regulation. "With every administration, especially with a changeover of parties, you have a different agenda. So the question is what items will the SEC want to look at potentially changing?"

One focus may be the sheer number of required CD&A disclosures, which result in a deluge of mandated data that often obscures, rather than illuminates, how executive pay is actually tied to performance. "You're being forced to calculate things differently across tables, and sometimes those figures are at odds with one another," explains Furman, who noted that the tabular pay-versus-performance required disclosure is a particular pain point. "You already had the summary compensation table—that's been a requirement for years—showing both cash that's already been earned and equity that's been granted, but not yet earned. Then you layer on pay-versus-performance, with its own intricate calculations, and the two perspectives are apples and oranges."

SCRUTINIZING SECURITY

Treatment of company-provided security arrangements as a reportable perquisite under executive compensation disclosure rules was another area of scrutiny during the roundtable discussion. The business impact of recent high-profile corporate safety incidents have spurred interest in implementing personal security arrangements for executives. However, the prospect raises questions about whether such arrangements would be viewed as a benefit and therefore need to be included in summary compensation.

"Most companies consider security benefits not necessarily as a perquisite for the employee so much as important for the company operationally," explains Abromowitz. "But many have been hesitant to provide or limited the magnitude of arrangements out of concern that doing so would invite scrutiny from proxy advisors. However, since the murder of the UnitedHealthcare executive, we have seen an uptick in clients reviewing and enhancing their personal security arrangements. This is an area that companies should follow closely and be prepared to address any change the SEC decides to make."

However, while signs suggest that compensation committees may hope for regulatory reforms simplifying disclosure requirements and easing compliance, the timing and extent of changes remain uncertain. The SEC has announced plans for a public comment period, suggesting significant rule-making updates are unlikely in the near term.

In the meantime, Furman recommends focusing on enhancing the clarity and usefulness of existing disclosures—particularly in the CD&A—so that investors and proxy advisors can better understand the rationale behind pay decisions. “Investors are looking for CD&As to explain the why behind compensation decisions,” he explains. “What is the business rationale? How is our pay tied to performance? There are ways, things you can do today, to enhance disclosure, improve clarity and really drive home that ‘why’ to get ahead of this and ultimately improve the readability and the ease of understanding from investors.”

IN THEORY AND IN PRACTICE

Including a realized or realizable pay analysis in the CD&A is one way companies can enhance transparency around pay and performance alignment. Realized or realizable pay analyses compare the compensation that a CEO or other named executive officer was intended to receive with what he or she actually received over the length of a long-term incentive plan, often three to five years. The calculation factors in actual bonus payouts, the earned value of performance-based equity awards (which often pay out between 0 and 2x depending on goal achievement) and the value of stock-based awards based on the company’s share price over time.

This type of retrospective analysis provides meaningful context to investors and proxy advisors. This can be particularly useful if compensation outcomes appear misaligned when viewed through the lens of a summary compensation table, which reflects accounting values rather than realized economic value. “For example, a company might have a five-year program intended to compensate their CEO at the median of the market, say, $5 million through a base salary, target bonus opportunity and grant of long-term incentives in time-based and performance-based stocks,” explains Furman. “But if the stock is down and the analysis shows that he’s only realizing 50 percent of that targeted amount, that’s an indication that the pay-for-performance aspect of the program is working as designed by scaling back pay when results fall short.”

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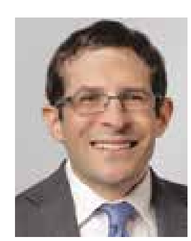
Providing this type of supplemental disclosure allows companies to communicate the logic behind their pay decisions, highlighting the integrity of their incentive structures and reinforcing their commitment to shareholder-aligned governance. The approach is a proactive measure companies can take to show that a pay program is delivering outcomes that reflect actual company performance. While not yet standard practice, companies like Exxon Mobil, Medtronic, Chevron and Marriott reported realizable pay in their most recent proxy statements.

Investors and proxy advisors also increasingly seek greater detail on annual and long-term performance goal setting. “They want an understanding of why goals are chosen, how these goals are calculated and what kind of adjustments are being done,” says Furman, who advises companies to consider prefacing the CD&A with a letter from the board chair or compensation committee chair explaining the key tenets of the compensation program.

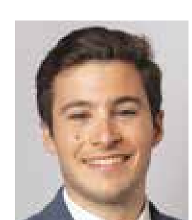
“Often a letter is put in place after a say-on-pay challenge to communicate to investors what the company did, how they’re taking it seriously and how their programs align with the company’s performance over a period of time,” he explains. “It will speak to the incentive payouts, to operational performance, total shareholder return (TSR) and other commitments that they’ve made to investors through outreach. It’s ultimately intended to put all of the most important points or takeaways of the CD&A upfront for the reader so you don’t have to go digging through the CD&A for this information.”

By proactively enhancing the clarity and narrative of the CD&A through tools like realized pay analysis and letters from board leadership, companies can bridge the current gap between regulatory compliance and meaningful investor communication. Taking these steps not only helps companies stay ahead of potential regulatory change, it reinforces the integrity and alignment of executive pay programs and helps prepare companies for future SEC rulemaking, says Abromowitz.

“The biggest scrutiny we see companies get from proxy advisors and shareholders is lack of disclosure,” he says. “So even as the SEC begins to question the utility of some of these burdensome disclosures, the demand for transparency from stakeholders—that macro trend we’ve seen over the past 10 years—will continue. The companies that strengthen disclosure quality on their own terms now, rather than wait on regulatory outcomes, will earn goodwill from the investor community and benefit in the future from that history of enhanced transparency.”



Michael Abromowitz is a principal at FW Cook who advises companies on all aspects of executive and board compensation.



Jose Furman is a principal at FW Cook who advises companies on a broad range of executive and director compensation matters.

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