Food for Thought: Upcoming SEC's Pay-for-Performance Rules

The SEC is supposedly working on finalizing pay-for-performance disclosure rules under the 2010 Dodd-Frank act. This document discusses a few thoughts for the SEC to consider acknowledging that this is a complex topic, and it would be very difficult to find a methodology that is acceptable to all interested parties.

I think the SEC should follow a principle-based approach while providing a framework for companies to follow. The framework could provide that:

- Companies are required to disclose a quantitative pay-for-performance analysis
- Companies should use a consistent methodology one year after another. A company could make periodic changes to its methodology with a detailed explanation of rationale for changes in the year of change
- Each company should decide the right time period (3-year or 5-year or something else) to compare pay with performance
- Both pay and performance comparisons should be relative to a peer group(s) as determined by the company
- If a company concludes that relative comparison (pay and/or performance) is not appropriate, the company should disclose its rationale for such a conclusion
- Each company defines the appropriate performance measures for this analysis - use of stock price as one of the measures is preferred but not required and this should not be the sole measure
- Pay refers to actual pay ("realized pay") or target pay, subject to a company's discretion. Since peer companies' pay and performance data for the most recent year is not likely to be available when proxy statements are filed, companies should be allowed to defer the analysis until all data is available
- Where applicable, besides pay provided to the current CEO, companies should include pay provided to its retired/terminated CEOs in the last fiscal year. Companies should be allowed to combine pay provided to multiple CEOs or provide a separate pay-for-performance disclosure for each CEO
- Companies should be allowed to exclude the most recent fiscal year(s) from the pay-for-performance analysis since, in most cases, it is almost impossible to judge if pay decisions made in the most recent fiscal year(s) achieved their objectives at the end of the last fiscal year
- Use of models (e.g., Black-Scholes, Monte Carlo) should not be required to estimate pay under ongoing performance plans and stock options, but is allowed if a company prefers to use models to provide additional information
- Quantitative disclosure should be supplemented by qualitative disclosure to provide additional context
- Analysis should exclude pay components that fall under "All Other Compensation" and "Change in pension value and non-qualified deferred compensation earnings" portion of Summary Compensation Table

- Companies should have flexibility to deviate from the framework as long as they discuss rationale

Target pay for a year includes salary, target bonus[1] for the year, and long-term incentives (e.g., stock options, restricted shares, performance shares) granted in the year but subject to future performance. Actual pay is much more complicated and refers to amounts (cash or value of shares) actually paid to an executive considering target pay and actual performance.

Long-term incentives make the pay-for-performance analysis very complicated because some of these incentives are generally earned over three to four years and denominated in shares. If a company uses stock options, the rest of its long-term incentives are generally earned over a period of five to ten years and actual pay from stock options is subject to decisions made by individual executives. The SEC rules should not require use of models (e.g., Black-Scholes or Monte Carlo) to estimate value of long-term incentives to keep the disclosure simple and "more real."

The SEC's 2015 proposed rules do not require a comparison of pay. I think a relative comparison of pay is required to provide additional context and make this disclosure comprehensive.

If the SEC conclude that disclosure of target pay or actual pay is confusing or not practical, it could require companies to disclose CEOs' W2 compensation – taxable compensation. This is the simplest disclosure without significant additional work, but this could also be the most misleading disclosure for various reasons. The SEC could address the "misleading" disclosure concern by allowing companies to provide this information for a long time period (e.g., average over the last ten years) to "normalize" pay. Further, companies could provide supplemental data to provide context. For example, a company could provide weighted-average time period[2] over which the disclosed W2 pay was earned and discuss performance over the same time period.

I am suggesting exclusion of "other compensation" as well as "pension and deferred compensation" from the analysis to keep the disclosure simple. As we know, generally, these pay components are not a significant driver of companies' pay-for- performance philosophies.

I have provided an example below using a very large company's CEO data over the last 10 years to illustrate compensation calculation under various methods, including target pay, actual pay, W2 pay, and disclosure under the 2015 SEC proposed rules.

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[1] Bonus payable after the year ends, generally in cash, if target performance is achieved.

[2] Example of weighted-average time period – Let's assume an executive received total $3M compensation, including $2 million upon share vesting after a three-year time performance period and received $1 million cash bonus after one-year performance period. Weighted-average time period in this example is 2.3 years ($1M/$3M * 1 year + $2M/$3M * 3 years).

Sample Pay Calculation

$ in millions

						5 Yr Stock Price Performance			2015 SEC Approach*	
Year	Target Pay for Yr (3)	Actual Pay for Yr (2)	Weighted-Average Years - Actual Pay (6)	W2 Pay (5)	Weighted-Average Years -- W2 Pay (5)	Company	Index A	Index B	Summary Comp Table	Compensation Actually Paid
2011	$23	$97	8.9	$15	2.9	-24%	-60%	TBD (4)		
2012	$12	$14	3.2	$14	4.6	12%	-37%	-35%		
2013	$20	$25	3.4	$12	3.1	105%	90%	70%		
2014	$20	$29	2.8	$19	3.2	67%	87%	90%		
2015	$27	$64	3.7	$36	5.2	77%	64%	55%		
2016	$28	$44	3.6	$22	2.7	198%	143%	159%	$27	$31
2017	$30	$57	3.7	$141	9.1	178%	130%	131%	$28	$37
2018	$31	TBD (1)	TBD (1)	$18	2.9	90%	48%	38%	$30	$18
2019	$32	TBD (1)	TBD (1)	$107	6.6	154%	70%	72%	$32	$64
2020	$32	TBD (1)	TBD (1)	$63	5.9	122%	69%	53%	$32	$44
Average (2011-17)	$23	$47	4.2	$37	4.4	88%	60%	78%		

* Selected data for the CEO is presented for the last 5 years. Compensation Actually Paid includes salary, bonus, RSU vested, and in-the-money value of stock options in a year. SEC approach requires additional information and fair value calculation to determine value of vested stock options.

(1) Restricted shares to vest in future based on performance

(2) Example- $57M actual pay for 2017 includes salary paid in 2017, cash bonus paid in 2018 for 2017 performance, and value of shares vested in 2021 that were granted in 2018 based on 2017 performance.

(3) Example- $30M target pay for 2017 includes salary, target cash bonus (payable in Q1 2018), and shares award granted in Jan 2018 considering 2017 performance. Analysis assumes that target bonus was the same as actual bonus since the company does not disclose target bonus.

(4) Not disclosed by company; source for all performance data is the company's proxy or 10k filings

(5) Example- 2017 W2 pay includes salary for 2017 that was earned over 1 year in 2017, cash bonus for 2016 that was earned over 1 year (2016 performance) and paid in Q1 2017. 2017 W2 pay also includes shares vested in 2017 that were granted in prior years based on 2013 and 2014 performance.

The rest of 2017 W2 pay includes taxable compensation from stock option exercises in 2017. These stock options were granted in 2008.

Total 2017 W2 pay of $141M was earned over a weighted-average period of 9.1 years considering amount of payment and performance period over which each amount was earned.

(6) Example- 2017 actual pay of $57M includes salary that was earned over 1 year in 2017, cash bonus that was earned over a 1 year performance period in 2017 and paid in Q1 2018, and value of shares vested in 2021 that were earned over a 4 year period that started in 2017. Total actual pay of $57M was earned over a period of 3.7 years considering amount of payment and performance period over which each amount was earned.

If we stay with the 2015 proposed disclosure approach, it is most likely to become useless like the CEO pay ratio disclosure – all companies will follow the required disclosure rules, but shareholders are likely to ignore it because it is not going to provide any meaningful information. We should recognize that pay-for-performance analysis is a complex topic and the SEC should allow each company to make its own case while following guidelines provided by the SEC.