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SEC Regulations and Executive Compensation

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Post-SEC rule revision, talent managers must balance compliance, competitiveness and shareholder responsibility to design compensation packages that attract and retain the best talent.

Thanks to the less-than-stellar behavior of executives at companies such as Enron, WorldCom and Tyco, there is a general perception in the media that executive pay has gotten ahead of itself.

In 2006, the SEC adopted revisions to its rules governing the disclosure of executive compensation, party transactions, corporate governance matters and compensation arrangements, among other things. The revisions, the first since the early '90s, were necessary because the agency found pieces of compensation weren't being disclosed or were not disclosed clearly.

Adjustments were made to catch innovative ways of compensating senior executives, and as a result, talent managers and compensation experts are seeing a lot of change in executive-pay disclosure.

"It began probably as early as 2000 with the blowups with Enron and other major companies," said Ed Speidel, senior vice president at Radford Surveys and Consulting, a business unit of Aon focused on executive and broad-based pay.

"Some of the actions around executive pay at that point in time have gotten worse," he said. "Prior to Radford, I worked at other Fortune 500 companies' boards and comp committees. [They] didn't understand the interconnection of contractual benefits, supplemental executive retirement-plan benefits, changes in pay and long-term incentives and how they all come together to bring a much higher level of executive pay than anyone expected."

"The use of stock is essentially what the SEC is looking to protect. In the very recent past, the SEC has enforced regulations more because of problems that came up," said Tom Casey, senior vice president at nGenera. "The Enron scandal is the best one. People were encouraged to have stock as part of their compensation and retirement plans, encouraged by the CEO to not sell and to keep it for as long as they could. And people lost their retirements and everything else. There needs to be somebody that looks at the interests of shareholders, where stock is a vehicle of compensation in the companies in which they choose to invest."

Expert Assistance

Stock isn't the only consideration on talent managers' executive-pay agenda. They must work closely with compensation experts to create transparent, competitive and comprehensive compensation packages that reward and motivate executives without raising red flags.

"Everything has to be disclosed: amounts, events (what happens when executives retire or voluntarily resign) and performance measures (what does it take to earn the bonus or the stock award, profitability, growth targets)," said Kevin Nussbaum, president of consulting firm CBIZ Human Capital Services. "Nobody will ever get into any issues with fair-market-value compensation for fair-market-value performance.

"If your performance measures are aligned at the median and your pay structure is aligned at the median, you're fine. It's when you start paying people at the 90th percentile for 50th-percentile performance that problems appear."

Compensation committees are looking for senior talent managers to ensure compensation programs balance within the new understanding of what is reasonable, transparent and performance-oriented, Speidel said. This requires understanding the business, shareholder expectations, predictions for growth, revenue and profitability, and prospects for stock price.

"If I'm looking at growth in revenue or profitability year over year in my bonus plans of only 5 percent or 8 percent, but the investment community is expecting 15 percent in growth and revenue, that's a disconnect," Nussbaum said. "There's a real struggle sometimes if I'm a senior talent manager with who's my boss. Your boss is the shareholders, the board, the compensation committee."

Casey said talent managers also have to know competitive executive salaries in their markets and figure out the best mix of compensation vehicles to appeal to different employee groups. This involves metrics.

"Talent managers, as a general rule, don't like measuring anything," he said. "Most HR or talent management departments measure turnover, but they don't measure turnover for a critical group. And they don't measure impact of that turnover in dollar and cents terms.

"There are five things they should be measuring: employee engagement, turnover for people in critical positions — not just senior officers — time to productivity and time to fill a position. The other one is the performance of people they bring in for the first year, separate and distinct from overall performance.

"If employment engagement is high, fair. If turnover is low, fair. If time to fill is good, you're paying well but maybe not outrageous. If time to productivity is low and performance is good, you know you're hiring good people."

Paying the Right Price

Nussbaum said it may be hard for many talent managers to get the right compensation answers unless they're experienced in compensation modeling and design. Using the fair-market-value standard helps.

"Fair-market value by its definition is 'willing buyer, willing seller,'" he explained. "You have that negotiation when you're first trying to attract somebody to your organization, and generally that initial employment deal is the best source of fair-market value out there. That person wants to get the best deal for them, and the company wants to limit its exposure as much as possible and still get the right person."

Over time, many things can impact fair-market value: historical performance, industry movement and the organization itself. Nussbaum said talent managers must be prepared to answer questions such as, "Are bonuses still being paid? What performance measures is bonus pay based on? What are performance targets in the industry? What are comparable companies paying, and what are comparable companies requiring as performance standards to achieve those payouts?"

"This season, as those proxies start coming out, the information is even more voluminous than it was last year. And the SEC has said it wants to see more," Nussabum said. "Short term, it will lead to higher levels of scrutiny and governance on compensation, but long term, it won't be any different than what happened in Major League Baseball. The more you disclose, the more compensation escalates — the more comparability we have. The star performers are going to make more money."

Transparency

Talent managers have a responsibility to executive boards and compensation committees to ensure the level of pay provided to executive teams is based on tangible performance. All pay decisions must be defensible, requiring a high level of comparative analysis in the compensation-design process. Talent managers' executive-compensation programs must illustrate how to drive shareholder value, increase share price and be competitive and reasonable.

"There have been problems with excessive payments for mediocre performance with a significant disparity between what the CEO is making and what his or her next-level executives are making. This has led to a lot of criticism, and in many cases it's justified," said Speidel.

"I see a dramatic difference in the way compensation committees and boards viewed executive pay five, 10 years ago than how they do now. Then, the focus was around being competitive. That's still true, but now there needs to be clear links to performance and links to increased shareholder value."

The new proxy-disclosure rules ask compensation committees to detail the connection between executive pay and performance in a compensation discussion and analysis that explains how they make decisions, the process or rationale for those pay decisions and how they link back to actual company performance in a given year.

"HR professionals need to think more carefully about the design of these programs," he said. "There's much more transparency spelling out costs — particularly on change and control and in termination events — understanding from a shareholder perspective more clearly the amount of wealth creation coming from equity and other things. As I design, I need to make sure there is enough stretch to force the executive to perform well, whether it be increased revenue, profitability or things along those lines."

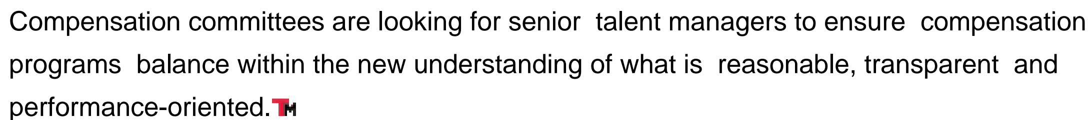
A company's performance levels; total shareholder return, or growth in revenue; and profitability, or operating income, all must compare favorably with its overall level of executive payment. Speidel said if there's a disconnect — if a poor-performing company still is giving out top-level payment — that compensation committee didn't do its job.

"We're starting to see more companies say, 'You're only going to get your bonus if you meet a financial or business milestone that is going to increase the overall value of the company.' What was criticized over the past couple of years around executive pay — no linked performance, excessive use of options and equity when there was not a lot of value coming from it — those things are being changed," he said.

Speidel said talent managers should have an overarching philosophy about pay, focus specifically on long- and short-term incentives, know what the investment community and shareholder rights groups are focusing on and think carefully about contractual arrangements and whether they provide too much of a safety net or are so excessive that they could hurt a deal.

"Right now, employment agreements, severance details, change-of-control agreements, acceleration of equity, all of these things are being criticized," he explained. "If I bring in an executive or renegotiate an executive contract, I need to look at the contract in the current environment.

"We're starting to see HR people look carefully at reducing severance to maybe one-time base and bonus. A lot of boards, comp committees and advisers are saying, after the two-to-three-year period within the company where you're adjusted and the risk of termination is low, 'Do you really need a not-for-cause termination agreement?' You need to have much stronger justification and rationale for providing programs than you ever have."



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