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for a focus on the “principles underlying the registrant’s executive compensation policies and decisions and the most important factors relevant to analysis of those policies and decisions,” but it does not actually call for the *analysis* itself. Further, the specific examples cited in Item 402(b)(2), while admittedly a non-exclusive list of material items to consider, only touch on (and in some cases obliquely refer to) the analytic tools that companies use—or should be using—when setting executive pay.

An “Analysis” Caption. In order to address these concerns, and to ensure that the intent of the rule is clear long after the current focus on the rule has waned, the SEC should require a separately captioned “Analysis” section of the CD&A. This separately captioned section will focus companies on the requirement to specifically discuss the key analytic tools, the findings from the analysis and how the findings were used in assessing and setting compensation. And, it would enable shareholders reading the CD&A to “find the beef.” Within this separately captioned section would be separate analytical subsections for each pay element. The SEC has successfully used mandated captions to highlight particular types of disclosure—for example, Item 407 of Regulation S-K requires disclosure under the specific captions “Compensation Committee Report” and “Compensation Committee Interlocks and Insider Participation.” Just as these specific captions focus attention on the particular disclosures (notably for not only shareholders and potential investors, but also for companies and their board committee members), a captioned “Analysis” section of the CD&A would highlight the lynchpin for the overall compensation picture, *i.e.*, the “why” that puts the rest of the disclosure into context. Without a separately captioned section, it is too easy for companies to pass off overly general assertions as their analysis, such as declaring that actions were taken for the most part to preserve the “competitiveness” of the compensation program. (See, *e.g.*, the Special Supplement to the January-February 2008 issue of *The Corporate Counsel*.)

Highlighting the Analytic Tools. In addition to adoption of a captioned section, Item 402(b)(1) of Regulation S-K should be revised to specifically call for disclosure about the analysis undertaken with respect to each of the other six elements that are already listed. Further, the 15 “suggestions” in Item 402(b)(2) need to be augmented with references to specific analytic tools. Currently, the Item specifically names perhaps the least effective analytic tool—benchmarking—which may have the unfortunate effect of putting too much emphasis on this already over-used approach. In order to fully identify the range of potential analytic tools, the list should also include specific references to whether the company has utilized tally sheets, a wealth accumulation analysis and/or an internal pay equity analysis, including how and why the particular analysis was used, the findings from the analysis and then what decisions were made and what compensation changes were considered/implemented and why. These key analytic tools—as often alluded to in the Staff’s comments during its targeted review—should be specifically enumerated as potential topics for discussion in the CD&A.

Performance Target Disclosure

Under the current rules, companies may omit performance target measures in reliance either on a determination that the performance target levels were not (i) material, or (ii) based on a conclusion under Instruction 4 to Item 402(b) of Regulation S-K that the disclosure of these numbers would cause competitive harm. When performance target levels are omitted and adequate disclosure about the “degree of difficulty” in meeting those targets is not provided, investors are left without a clear picture of the link between pay and performance. As a result, compensation disclosures across companies are often not comparable, and perhaps the most critical information for understanding what motivates the named executive officers remains unclear. It seems that, to date, many companies have been willing to “take a chance” on the Staff questioning their non-disclosure decision in the course of a review.

Mandatory Performance Target Level Disclosure. Based on this experience, the SEC should recognize that its principles-based approach may not have adequately promoted fulsome disclosure of performance target measures. The required analysis in the CD&A is not possible when some of the most important data points are omitted on materiality or confidentiality grounds. The SEC should consider adopting an express requirement in the CD&A (and for the narrative disclosure accompanying the Summary Compensation Table under Item 402(e)) that mandates disclosure of performance target levels for completed periods, as well as a requirement to discuss current period or future period target levels, but only if material to an understanding of the disclosure and analysis about the company’s compensation policies and decisions for the last completed fiscal year. The performance target disclosure should be required to be presented in tabular form.

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Retaining a True Competitive Harm Standard. Given that there is still the potential for competitive harm from the release of sensitive information about target levels, the SEC could retain the current standard for omission when the target levels constitute confidential commercial or financial information. When the amendments were originally adopted in 2006, no new standard for confidential treatment was established; rather the SEC sought to rely on the familiar (and historically high) hurdle for omitting confidential information from filings under Securities Act Rule 406 and Exchange Act Rule 24b-2. This standard has not been the problem; the problem has arisen in applying the standard to a company's particular circumstances.

Therefore, the SEC does not need to change this well-established, pre-existing standard. However, instead of leaving it for investors, shareholders and the Staff to guess whether performance targets were omitted on confidentiality grounds, the SEC should require that the company include an affirmative statement in the disclosure that the specific target number was withheld based on a claim of confidential treatment (as is done today when confidential information is omitted from an exhibit under Rules 406 or 24b-2). The Staff should then seek to enforce the traditionally rigorous standard for confidential treatment through its comment process (after the fact), to ensure that target levels are not being inappropriately withheld. When target levels are withheld without an adequate basis under the confidential treatment standard, then the Staff should require an amendment to the filing to correct the information—just as it would if confidential treatment were denied for a portion of an exhibit today.

Finally, disclosure regarding how difficult it will be for the executive or how likely it will be for the company to achieve the target levels (as now contemplated in Instruction 4 to Item 402(b) when target measures are omitted) should be required in *all* circumstances, *i.e.*, when targets are disclosed or when targets are omitted. This disclosure should serve as a basis for the critical analysis of the target measures and their relationship to the named executive officer's or the company's performance. Investors have been asking for this disclosure in all circumstances, and by adopting it as an express requirement, the SEC will aid in facilitating an understanding of target measures and go a long way toward addressing the "where's the analysis?" problem discussed above.

Use of Discretion. With all of the recent focus on bonuses at financial institutions, the SEC should also consider expanding disclosure requirements directing companies to discuss the extent to which discretion can be utilized and was used in connection with making bonus decisions. This disclosure is all the more important in times when issuers are not meeting incentive targets and compensation committees are faced with determining whether and how to compensate executive officers. Given the "pay-for-performance" veneer of most executive compensation programs, it has become more critical to explain why bonuses are warranted—particularly when bonuses are preceded by layoffs or when rank-and-file bonuses have been scaled back or eliminated. Further, when issuers have layoffs, and bonuses are paid to NEOs, it is important for those issuers to analyze and disclose in the CD&A whether the bonus formula would have been met without the cost savings that resulted from the layoffs (as opposed to bonuses earned from real growth).

Presentation of Equity Awards in the Summary Compensation Table

Perhaps nothing has contributed more to the complexity—and confusion—regarding the new executive compensation disclosures as have the hastily adopted December 2006 amendments to the Summary Compensation Table and related disclosures, which mandated the presentation of the amounts expensed for equity awards instead of their grant date fair value. Had the SEC stuck with its original rules, many of the negative issues that plagued proxy statements over the past couple of proxy seasons (such as overly long and unduly complex CD&As, competing total compensation presentations in proxy statements and in press reports, lengthy discourses on the fine points of the recognition model of FAS 123(R), and negative total compensation numbers) could have been avoided.

Significant Complications. In today's down market, issuers are grappling with how vesting conditions in grants made in prior years impact the accounting for their equity awards and the resulting presentation in the Summary Compensation Table. While for service-based equity awards, compensation expense as shown in the Summary Compensation Table is essentially fixed, *i.e.*, the grant date fair value (disregarding any estimate for forfeiture) is spread out ratably over the service/vesting period, performance-based and "liability" equity awards can be subject to wide swings in the amounts reported year to year in the Summary Compensation Table. These swings can impact the named executive officers that are reported in

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the tables from year to year, and reversals or negative expense numbers arising from the accounting for these awards may cause negative numbers to be reported in the “Stock Awards,” “Option Awards” and “Total Compensation” columns of the Summary Compensation Table. In the current climate, investors will be very confused upon finding negative compensation numbers in the Summary Compensation Table for named executive officers, which has the potential to inflict even more damage to the credibility of the compensation numbers.

Return to the Original Approach. It is not too late for the SEC to show that it “gets it” and to amend Item 402 to reflect the original approach of including the grant date fair value of equity awards in computing total compensation. The SEC seemed to acknowledge the problems with the current presentation when it announced the interactive Executive Compensation Reader—which permits the Summary Compensation Table to be “sliced and diced” so that total compensation can be computed using the grant date fair value of equity awards instead of the expensed portion of the awards. While this may be useful for investors of the small group of companies that are covered by the Reader, it does not change the impact that the expensing approach has had on the determination of named executive officers who show up in the table and how issuers have grappled with explaining the oftentimes anomalous results.

The issue here is not that one approach produces larger numbers than the other; rather it is that the total compensation number in the proxy statement that was going to bring uniformity and a “bottom line” approach to compensation disclosure has been rendered largely irrelevant, and that has compromised the ability of companies to provide the necessary level of clarity and analysis in the CD&A and elsewhere in the disclosure.

Alternative Presentations. If the Commission is not willing to adopt the pre-December 2006 approach for equity awards, then it could move to a more principles-based approach for presenting the Summary Compensation Table information. Instead of seeking to limit the manner of presentation of an “alternative” Summary Compensation Table, as was suggested in comment letters and the October 2007 Staff Report, the SEC could codify an approach that permits the use of some reasonable alternative presentation of the Summary Compensation Table information in situations where that alternative presentation is consistent with the way in which the compensation committee views and analyzes the information when making its compensation decisions. By taking this approach, the SEC could mandate the manner of presentation and the required information for an alternative table if it is elected, and could even retain the “expensing” table as the “default” approach in order to ensure comparability across companies and over time. Our clear preference, however, is to face the problem squarely and return to the original, pre-December 2006 approach.

Post-Termination Disclosure—The Necessity for Real “Walk-Away” Numbers

The 2006 amendments went a long way toward eliciting more disclosure about amounts payable under termination and change-in-control arrangements. Unfortunately, the amendments did not go far enough—more disclosure is not necessarily better when it is dense and unfocused. The way that the SEC can now address these concerns is through an approach that the Staff actually suggested to some companies through its targeted review comments, which would be to require total amounts for post-termination and change-in-control scenarios, rather than just presenting the incomplete “raw” data.

Require a “Walk-Away” Number. As was noted in our September-October 2007 issue and in the model CD&A disclosures provided in the January-February 2008 issue of *The Corporate Executive*, inclusion of total “walk-away” numbers provides the best means for avoiding “surprises” down the road in the event that the termination or change-in-control provisions are triggered. Companies have demonstrated that presenting these numbers can be done—Starbucks filed a proxy statement last year that included a table highlighting the total walk-away numbers (both with accelerated vesting of stock options and without accelerated vesting) upon termination or change-in-control scenarios. As companies and their compensation committees rethink the necessity of severance and other post-termination and change-in-control benefits, the need for disclosure of true walk-away values will increase, so that the analysis (or lack of analysis) underlying their decisions is transparent for shareholders.

The objective of presenting useful walk-away numbers cannot be achieved only through the suggestions from the Staff’s comments seeking totals in the Item 402(j) disclosure. For the purposes of economy in presentation, the SEC did not require that the narrative or tabular disclosures of amounts payable upon

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termination or change-in-control scenarios include every element of compensation; instead, issuers may omit amounts payable under pension and non-qualified deferred compensation plans under Instruction 3 to Item 402(j) if those benefits are not enhanced or vesting is not accelerated. As a result, the currently required disclosure gives only a partial picture of the overall benefits, and insufficient data in one place to compute a full walk-away amount.

Moreover, the “static” analysis contemplated by the current Item 402(j) requirements (which assumes a triggering event happens at the end of the last fiscal year and at the end-of-year stock price) does not provide the complete walk-away picture. The SEC’s disclosure requirements should track the analysis that compensation committees need to be undertaking, and include in the walk-away value not just unvested equity grants, but also previously exercised grants and projected future grants based on the assumption that they will be made on the same basis as the most recent award. Pension benefits should also be projected out as well in computing these walk-away numbers. (See, for example, the excellent model table provided jointly by Deloitte Consulting and Watson Wyatt set forth in the materials from the “5th Annual Executive Compensation Conference” available on CompensationStandards.com.) For the purposes of public disclosure, the SEC can specifically indicate that the safe harbor for forward looking statements is available for the projected walk-away amounts.

Standardization is Necessary. Without disclosure of the bottom line impact of post-termination and change-in-control provisions, the disclosure required by Item 402(j) has largely been unfocused and often confusing. In fact, the Item 402(j) disclosure has tended to be the second longest section of the compensation disclosure after the CD&A. While the principles-based approach of allowing companies to format this disclosure as they saw best was perhaps a noble effort, it is clear from the first two years of results that some level of standardization is necessary in order to make the disclosure useful. For the purpose of facilitating a presentation of the total walk-away amounts, an approach similar to the Summary Compensation Table should be adopted. In so doing, the SEC can still preserve some flexibility for companies in determining how best to present various termination or change-in-control scenarios, but it can mandate the specific elements of compensation that must be included—as well as the manner of presentation for those elements. Further, issuers should be required to disclose, in footnotes to the numbers, how the numbers are calculated, including relevant assumptions.

Enhanced CD&A Disclosure. Further, the SEC should amend Item 402(b)(2)(xi) to specifically require a complete analysis of the “why” behind the termination and change-in-control arrangements. Currently, the item requirement only addresses the basis for selecting particular events as triggering events, without directing companies to delve into the underlying rationale for the arrangement in the first place. In particular, the requirement should direct companies to address the overall consideration of a named executive officer’s wealth accumulation when severance, retirement or change-in-control benefits are established or maintained. The resulting disclosure should include an adequate justification for severance, retirement and change-in-control provisions, particularly where a CEO may have already accumulated several lifetimes of “security” so that there is no longer a need for the safety net provided by these provisions. In order to ensure that the compensation committee considers the consequences (including costs) of such arrangements, the SEC should require a statement in the CD&A or in the Compensation Committee Report that the committee reviewed all of the elements and determined “all aspects of the program, including severance, were reasonable and necessary.” And, the instruction should state clearly that saying “to be competitive” is not analysis. In these times, it has become very clear that justifying an action because “everyone else is doing it” does not satisfy one’s fiduciary obligations to the company and to shareholders.

Requiring Risk Analysis Disclosure in the CD&A

In consideration of the Congressional mandate to financial institutions receiving TARP funds, companies are beginning to focus on risk, and its implications, in their CD&As. In the past few months, it has become clear that the Staff is expecting discussion of these matters by all companies, not just financial institutions. As John White, the former Director of the Division of Corporation Finance stated at our conference last year: “Would it be prudent for compensation committees, when establishing targets and creating incentives, not only to discuss how hard or how easy it is to meet the incentives, but also to consider the particular risks an executive might be incentivized to take to meet the target—with risk, in this case, being viewed in the context of the enterprise as a whole?” In order to level the playing field for all companies, the SEC should revise the CD&A requirement to specifically mandate the sort of risk-based disclosure and compensation

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committee certification that is now expected of the institutions receiving TARP funds. A new disclosure mandate and annual certification will encourage issuers to consider the extent to which elements of pay packages encourage unnecessary and excessive risks, which will serve as an important backdrop for the overall analysis of compensation that needs to be described in the CD&A.

The Need for a Specific 162(m) Disclosure Requirement

When the SEC's specific mandate to address the applicability of Section 162(m) was omitted in favor of principles-based disclosure, it seems that in some cases companies just decided to drop the Section 162(m) disclosure entirely (presumably concluding that it was no longer material), and those that have retained it include mostly boilerplate disclosure. (Readers should be reminded that the SEC in the adopting release for the 2006 amendments stated that the new approach "should not be construed to eliminate this [162(m)] discussion" as well as other "tax consequences to the named executive officers as well as tax consequences to the company.")

The Emergency Economic Stabilization Act of 2008 (the "EESA") and the US Treasury's Capital Purchase Program (the "CPP") has brought the SEC's Section 162(m) disclosure guidance to the forefront again, with a requirement that any participating institution agree, as a condition to participate in the CPP, that it will be subject to the \$500,000 annual deduction limit under Section 162(m)(5). Section 162(m)(5), which was added by Section 302 of the EESA, reduces the deduction threshold for the remuneration paid to senior executive officers during any taxable year from \$1 million to \$500,000, and it also eliminates the exception to the deduction limit for "performance-based compensation" as well as deferred compensation. Given the flexibility afforded by the SEC's CD&A requirement, however, a financial institution subject to the \$500,000 deductibility limit imposed in the EESA that chooses, nevertheless, to pay more, may (incorrectly) conclude that it does not have to disclose this fact in its proxy statement. The Section 162(m) compliance disclosures provided by participating financial institutions in proxy statements filed so far this proxy season underscore the problem. Companies are not providing the actual amounts paid to NEOs in excess of the caps, disclosing the lost tax deductions or explaining how those amounts—as well as the public's expectations of compliance—have been considered in the compensation analysis and decisions.

We believe that this information is material for all companies, especially given the current economic climate and needs to be disclosed in the CD&A; otherwise, shareholders will have no idea if the boards of their companies are sticking with the applicable restrictions or purposefully exceeding them. The SEC should require a separate, captioned section in the CD&A addressing Section 162(m), which should require actual disclosure of any amounts received by each executive that exceeded the deductibility cap, the amount of the foregone tax deduction and an explanation and conclusion that the board considered the issue and nevertheless decided to exceed the deductibility limits. This disclosure requirement should also specify that issuers must make clear that the foregone deduction is a real cost to the issuer.

Required Disclosure Concerning Hedging and Pledging Transactions

The SEC should revise the CD&A requirements to specifically require disclosure of pledging transactions. Item 402(b)(2)(xiii) of Regulation S-K currently calls for, if material, a discussion in the CD&A of "the registrant's equity or other security ownership requirements or guidelines (specifying applicable amounts and forms of ownership), and any registrant policies regarding hedging of the economic risk of such ownership."

While the item only refers to hedging, the principles-based approach of CD&A suggests that other, related material policies and decisions, such as an executive's exposure to margin calls for pledged securities, and the adverse incentive consequences associated with that sort of event, should also be discussed. Unfortunately, in too many cases, companies may be reading this example too narrowly, and not providing a complete picture of the extent to which executives are permitted to hedge or pledge away a portion of their stock. Recent market swings have focused attention on the significant downside of the practice of pledging shares by executives of public companies.

As a result of the disparate treatment between hedging and pledging arrangements in the CD&A and the beneficial ownership table, investors often do not get a full picture of the extent to which the executive's economic interest may diverge from their own. These arrangements represent a real concern for investors, because when things go bad for the executive, it has an impact on the value of all investors' holdings, as the forced selling of large blocks of stock to satisfy a margin call or as a result of a hedging arrangement

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can drive down the market price of the stock. Perhaps even more important for the long term, even when times are good, hedging and pledging arrangements raise a fundamental question as to whether all of the equity awards that an executive has accumulated will continue to act as an incentive, particularly when those shares may very well be called away pursuant to the terms of a margin loan or when some of the economic consequences associated with holding the securities have been hedged away.

A Few More Items

Some other aspects of the rules may require further SEC attention. For example, now that restricted stock is playing a greater role in compensation, the SEC should consider the presentation of restricted stock dividends in the Summary Compensation Table, so that these potentially large, material amounts of compensation are disclosed. With respect to the Outstanding Equity Awards Table, the disclosure would provide much better context to the analysis in the CD&A if the SEC required disclosure of the unrealized appreciation amount for outstanding stock options as well as tabular disclosure augmenting that table, which would present the cumulative amounts realized by NEOs from equity compensation, including those amounts realized from prior exercises or vesting. (See the January-February 2006 issue of *The Corporate Counsel* at pg 7.) In the area of perquisites, the SEC should consider adopting specific principles/requirements for how to measure aggregate incremental cost (particularly for airplane usage) in order to avoid the potentially material inconsistencies (and misleading amounts) that have emerged in light of the newly required disclosure about incremental cost methodology. (See the May-June 2005 issue of *The Corporate Counsel* at pg 1 and the January-February 2006 issue at pg 7.) As for benchmarking disclosure in the CD&A, the Commission should require that issuers disclose the specific criteria used to select the peer group.

Lastly, we know that the Staff has received various suggestions for changes to the disclosure of consultant involvement in the compensation process. Whatever course the SEC takes, the key questions that need to be addressed are whether the consultants had in fact: (a) suggested a particular course taken by the company and the underlying analysis; (b) actively agreed with that course and the underlying analysis; (c) passively acceded to that course of action and the underlying analysis; or (d) disagreed with the course of action and analysis. We also suggest that the SEC require disclosure of fees received by a consultant when the consultant performs services for management and the compensation committee. These insights are necessary for a complete understanding of the reasons behind the compensation decisions and a full description of the *actual* consultant involvement.

Time to Act

Now is the time to implement these changes, while momentum toward executive compensation reform continues to build and investors, Congress and others remain focused on the need for clear and complete disclosure. Just as Treasury has an obligation to address the TARP tax-related provisions, the SEC needs to do its part with respect to key disclosure fixes.

For more regarding the above suggestions, readers are directed to the Fall 2008 and Winter 2009 issues of Borges and Lynn's *Proxy Disclosures Updates* (available on CompensationDisclosure.com), the Special Supplement to the January-February 2009 issue of *The Corporate Executive*, the Special Supplement to the March-April 2008 issue of *The Corporate Executive*, the Special Supplements to the January-February 2008 and September-October 2006 issues of *The Corporate Counsel*, and the January-February 2006 issue of *The Corporate Counsel*. Readers should also consult with the up-to-the-minute resources available on CompensationStandards.com, including Mark Borges' Proxy Disclosure blog.

—JMB

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Editor: **David Lynn**, Partner, Morrison & Foerster and former Chief Counsel, SEC Division of Corporation Finance (dave.lynn@thecorporatecounsel.net).

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