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MEMORANDUM

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The New Executive and Director Compensation Proxy Disclosures — An Initial Analysis of the Recently Completed First Proxy Season Under the New Rules

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INTRODUCTION

The 2007 proxy season has just about completed for calendar-year public companies. This was the first year that the new compensation disclosure rules[1] applied. I read through the compensation disclosures of the Fortune 100 companies that filed their proxies in accordance with the new disclosure rules by April 14, 2007, as well as other public companies to see whether the new disclosures could be judged a success or a failure.

In contemplating the state of the compensation disclosures from this first proxy season under the new disclosure rules, a quote from Charles Dickens' masterpiece, *A Tale of Two Cities*, comes to mind:

> It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light, it was the season of Darkness, it was the spring of hope, it was the winter of despair, we had everything be-

[1] *Executive Compensation and Related Person Disclosure,* SEC Release Nos. 33-8732; 34-54302; IC-27444; File No. S7-03-06, issued Aug. 11, 2006 and published in the Federal Register, 17 CFR Parts 228, 229, 232, 239, 240, 245, 249 and 274, Sept. 8, 2006 [71 Fed. Reg. 53158] (the ''Initial Final Rules''). The Initial Final Rules were amended by the SEC in late Dec. 2006 in *Executive Compensation Disclosure*, SEC Release Nos. 33-8765; 34-55009; File No. S7-03-06, issued Dec. 22, 2006, and published in the *Federal Register*, 17 CFR Parts 228, and 229, Dec. 29, 2006 [71 Fed. Reg. 78338] (the ''Amended Rules''; ''Final Rules'' indicates a reference to the Initial Final Rules as amended by the Amended Rules).

For more information about the Initial Final Rules, see ''The Final Proxy Disclosure Rules: Implications and Issues,'' *Tax Mgmt. Compensation Planning J.,* Vol. 34, No. 11, Nov. 3, 2006. For more information about the Amended Rules, see ''The New Proxy Disclosure Tables: What Goes Where — Updated,'' BNA's Benefits Practice Center, Journal Reports: Law and Policy, Feb. 2007, or Exequity, LLP's Client Alert, ''SEC Amends Proxy Disclosure Rules to Align Better With FAS 123R,'' Dec. 2006, *available at* www.exqty.com

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fore us, we had nothing before us, we were all going direct to heaven, we were all going direct the other way – in short, the period was so far like the present period, that some of its noisiest authorities insisted on its being received, for good or evil, in the superlative degree of comparison only.

Similarly, in reviewing the compensation disclosures, they neither call for the depths of despair nor the heights of self-congratulation and praise. There were few companies that were entirely sinner or saint, with the majority trapped somewhere in between.

So where does that leave these mere mortal disclosures? The vast majority of companies appeared to generally attempt to comply with the new rules (some better than others, but that is often the case). But in some areas, companies were more hesitant than in others to comply with the rules (or, at least, the spirit of the rules) and provided disclosures that were less than transparent. Some companies appeared to have no issue in embracing the concept of full disclosure and took great efforts (and many pages) to ensure that their shareholders gained a truer picture of their compensation programs, policies, methodologies and decisions.

This was not an easy proxy season, which was made less so by the U.S. Securities and Exchange Commission's (SEC) last-minute changes to the rules in late December 2006.[2] Companies wanted to know how the rules applied, how the SEC would likely react to certain disclosures or lack thereof, and what other companies would disclose — no company wanted to disclose more than what the ''typical'' public company was going to disclose regardless of what the rules themselves called for. Most companies heeded the advice of Thomas Paine[3] and tried to hang together when it came to the manner in which they approached certain of the required disclosures (most notably, this appears to be the case with the rules regarding the disclosure of performance goals).

This article reviews the disclosures in order of the Item 402 compensation disclosure rules, starting first with general matters, determining named executive officers (NEOs), the executive compensation tables, and ending with the Director Compensation Table. The article then looks at some best practices from the new compensation disclosures. Throughout the article, issues that the SEC should address, clarify or revise before next proxy season are noted.

TRANSITION RULES

The Final Rules allowed companies to simply present a single fiscal year's worth of data in the applicable compensation tables during this first proxy season. Thereafter, companies will add a year to their disclosures until a full three years worth of information is provided in the tables. The vast majority of companies took the SEC up on this transition relief. However, a few companies, including Berkshire Hathaway[4] and Intel,[5] did present three years worth of data.

Having three years worth of data helped readers see the trends in the NEO compensation at these firms. However, pulling this information together, especially given the Amended Rules, certainly took significant time, effort and expense (well, perhaps not all that much time, effort, and expense for Berkshire Hathaway given the simplicity of its compensation programs and limited number of NEOs). For the companies that did offer three years worth of data, shareholders were in a position to get a better handle on how the disclosures for the last fiscal year under the Final Rules compared to the companies' prior disclosures under the old compensation disclosure rules.

DETERMINING NEOs

The changes to the proxy disclosure rules made it a little more challenging for companies to determine their NEOs this proxy season. First, the most obvious change requires that in addition to always showing the compensation of the Chief Executive Officer (changed to Principal Executive Officer or PEO in the Final Rules), the Principal Financial Officer or PFO (Chief Financial Officer in most cases) must be included.[6] According to one study, about 20% of S&P 500 companies did *not* list their Chief Financial Officer as an NEO under the old compensation disclosure rules.[7] Thus, the Final Rules forced a change in disclosure in about 20% of companies this past proxy season. Because the PFO was included at these companies, another executive who traditionally was included under the old proxy disclosure rules was left out.

Two of the less obvious changes to the determination of a company's NEOs under the Final Rules are (1) the breadth of compensation considered in determining NEOs,[8] and (2) the consideration of severance pay for departed executive.[9]

Due to the breadth of compensation that goes into the compensation amount used to determine the Top Three NEOs (other than the PEO or PFO) compared to the use of just salary and bonus under the old compensation disclosure rules, the individuals who ended

[2] The main impact of the Amended Rules was to require companies to include the full accounting expense amount recognized for equity awards during the last fiscal year in the Summary Compensation Table, instead of just the grant date fair value of the equity awards granted.

[3] ''If we do not hang together, we shall surely hang separately.'' Thomas Paine (1737 – 1809).

[4] *See* Berkshire Hathaway Inc.'s proxy filed Mar. 14, 2007, p. 6 (Berkshire Hathaway only included a Summary Compensation Table in its proxy, presumably because it had nothing to disclose under the other tables).

[5] *See* Intel Corp.'s proxy filed Mar. 27, 2007, pp. 28-31.

[6] Regulation S-K, Item 402(a)(3)(ii).

[7] *CFO Compensation Trends, An Analysis of S&P 500 CFO Pay Trends from 2003 to 2005*, Equilar, Inc.'s Executive Compensation Trends, Aug. 2006.

[8] Regulation S-K, Item 402(a)(2).

[9] *Id.*

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ISSN 0148-8295

up as the Top Three NEOs (other than the PEO or PFO) were sometimes very different than the executives who had traditionally been disclosed. In a number of cases, compensation decisions made during 2006 based on the old, familiar, tried and true maxims that worked under the old compensation disclosure rules caused much chaos. In many of these situations, signing bonuses (including equity awards granted to a newly-hired executive) were enough to vault a new executive ahead of more established executives, i.e., those who the company *thought* should be the ones being disclosed. In some cases, this lead companies to pay out bonuses in a way that ensured the ''right'' executive(s) made it into the compensation tables, e.g., some companies made sure that the executives they wanted to disclose in the tables received a bonus sufficient to assure their place amongst the disclosed executives.

As a result of having to consider severance pay when determining whether a departed executive must be included in the compensation tables, if a company had any executives who departed during the year, they invariably ended up in the tables, oftentimes filling up the maximum two spaces for departed executives under the Final Rules. Thus, if a company had executives who departed during the year and received severance, the company disclosed a minimum of six positions,[10] and often seven positions.[11]

THE CD&A

The Compensation Discussion and Analysis section (CD&A) is a completely new disclosure under the Final Rules that in some respects replaced the old Compensation Committee Report under the old compensation disclosure rules. However, the CD&A is broader than the old Compensation Committee Report and companies are given six (6) core questions to address and numerous other potential issues that may need to be addressed within the CD&A.[12] The CD&A is a report from the company about its key compensation policies, programs, philosophies, and designs.

However, most compensation committees still wanted to have a hand in reviewing and approving the CD&A before it was filed. The Final Rules do require a report from the Compensation Committee,[13] although one which is much narrower in scope than under the old compensation disclosure rules. The new report of the Compensation Committee is only required to address two things: (1) whether the Compensation Committee reviewed the CD&A with management, and (2) whether based on this review the Compensation Committee recommended it be included in the Company's annual report, proxy statement or information statement.[14] As with the old Compensation Committee Report, the name of each member of the committee must appear at the end of the report.[15]

Plain English / Readability

In preparing the disclosures required by the new compensation disclosure rules, the SEC sought to require companies to use plain English for their disclosures. The SEC previously had implemented plain English requirements for registration statements and apparently felt it was time for compensation disclosures to follow this standard as well. Unfortunately, in adopting the plain English rule, the SEC did not indicate how companies would be evaluated under the standard. The SEC may have thought companies would be able to figure it out on their own, but public companies typically desire some hint from a regulator as to what standard will be applied in judging compliance with a rule of this nature. The SEC reviewed the preliminary proxies filed under the new compensation disclosure rules in early 2007 and must not have thought companies were writing their disclosures in the proper style.[16]

Thus, in late March 2007, the SEC Chairman, Christopher Cox, shared the SEC's preliminary readability analysis of CD&A sections filed in accordance with the new compensation disclosure rules in a March 23, 2007 speech.[17] Chairman Cox criticized the readability of the 40 CD&As analyzed.[18]

The SEC had an outside communications firm analyze the proxy disclosures of those forty companies. The results were not what Chairman Cox had in mind. The Chairman cited new readability statistics that were employed in this analysis: the Gunning-Fog Index, the Flesch Reading Ease Test, and the Flesch-Kincaid readability algorithm.[19] Chairman Cox warned that the SEC ''may soon be looking to the Gunning-Fog and Flesch-Kincaid models to judge the level of compliance with the plain English rules.''[20]

According to Chairman Cox, the CD&As had a median length over 1,000 words longer than the U.S.

[10] PEO, PFO, Other Top Three, and Departed Executive 1.

[11] PEO, PFO, Other Top Three, Departed Executive 1, and Departed Executive 2.

[12] Regulation S-K, Item 402(b).

[13] Regulation S-K, Item 407(e)(5).

[14] *Id.*

[15] *Id.*

[16] A less nefarious rationale for the state of the narrative disclosures, as explained to the author by human resource executives at several companies, is that HR executives were tied up at the beginning of the year re-doing their compensation disclosure tables thanks to the Amended Rules, so they did not have time to go back and work with their legal counsel to craft more easily understood narrative disclosures.

[17] Speech by Christopher Cox, SEC Chairman: *Closing Remarks to the Second Annual Corporate Governance Summit*, Mar. 23, 2007, *available at* http://www.sec.gov/news/speech/2007/spch032307cc.htm.

[18] *Id.*

[19] *Id.* Note: For descriptions of these metrics, click on the ''find out more'' link on www.readability.info.

[20] Speech by Christopher Cox, SEC Chairman: *Closing Remarks to the Second Annual Corporate Governance Summit*, Mar. 23, 2007, *available at* http://www.sec.gov/news/speech/2007/

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ISSN 0148-8295

Constitution, an average Fog Index of 16.45 (about the same as a Ph.D. dissertation) and an average Flesch Reading Ease score of 34.86 (about the same score earned by articles in the *Harvard Law Review*).

Chairman Cox's reliance on these readability statistics took many by surprise and caused some distress amongst companies. The Chairman publicly mentioned these statistics as a means of assessing readability for the first time after the proxy season had commenced. These statistics were not discussed in the open meetings that lead to the release of the Final Rules and to the author's knowledge had not been mentioned during the SEC's decade-long effort to adopt plain English disclosure.

The author conducted his own analysis of the readability of the CD&As of the top 10 large, mid, and small cap companies to see if this was an issue that would impact only a few companies or the majority of companies filing disclosures under the Final Rules.[21] This analysis found readability levels similar to those discussed by Chairman Cox in his speech. The readability of other documents was also analyzed for comparison purposes, including the Final Rules themselves, whose readability was found to be significantly below the statistics cited for the new CD&As [to be expected given that these were rules and not disclosures, but it makes one wonder how rules that are not that readable by an eighth to twelfth grader would lead to CD&A disclosures that are]).[22]

There appears to be some room for improvement in both the readability scores of CD&As as well as in the Final Rules themselves. But as a practical matter, it appears that readability was an issue for the vast majority of CD&As that were filed this proxy season. Most likely the SEC will address the issue of readability when it releases its comments regarding the compensation disclosures this first proxy season under the Final Rules (which are expected to be released this Fall).[23]

For next year, the SEC might consider whether there is any way to effectively limit the length of the CD&As and other required disclosures that get filed. This seemed to be a concern of companies, investors and the media. One way might be for the SEC to require companies to preliminarily file their proxies if the compensation disclosures exceed some limit, perhaps dependent on the size and/or complexity of a company's organizational structure, number of employees, or market capitalization. Of course, the opposing view is, to paraphrase Abraham Lincoln, that the CD&As should be long enough to get their job done.

Disclosure of Performance Metrics/ Goals

Another area that is likely to draw SEC scrutiny when it releases its comments on the first round of disclosures under the Final Rules is the disclosure (or lack of disclosure) of performance metrics and goals.[24] Some companies had no problem disclosing their target performance goals, the actual performance achieved, and what this meant for the compensation that was paid out. However, it appeared that a majority of companies was unwilling to disclose their performance goals. These companies did not disclose the target goals and/or the actual performance achieved under each goal. They had to be relying on the exception regarding such disclosure granted by the Final Rules,[25] but not very many told the readers of their CD&As that this was what they were doing. Most just did not include the actual target performance goal, and to varying degrees, discussed how difficult it would be for the company and individual to achieve these undisclosed goals.

Stock Option and Equity Award Granting Policies

While the Final Rules required companies to discuss their equity award grant policies in their CD&A, the rules only specifically mention stock options.[26] However, the SEC's intent was a bit broader. So in interpretative guidance released towards the beginning of 2007, the SEC indicated that companies should discuss their grant policies related to all equity awards.[27] Most companies did this, but a few must have missed this or, hopefully, did not grant anything other than stock options.

Benchmarking of Compensation

The new compensation disclosures by and large did a great job of detailing that companies benchmarked compensation and most even went so far as to offer the companies used in such benchmarks. Some com-

spch032307cc.htm.

[21] Exequity's PULSE Study: Readability of CD&As Field Under the New proxy Disclosure Rule, Apr. 9, 2007, *available at* www.exqty.com under Surveys & Studies on the Reference Materials page.

[22] *Id.*

[23] Speech by SEC Staff (John W. White, Director, Division of Corporation Finance): *Keeping the Promises of Leadership and Teamwork: The 2007 Proxy Season and Executive Compensation Disclosures*, May 3, 2007, *available at* http://www.sec.gov/news/speech/2007/spch050307jww.htm.

[24] *Id.*

[25] Regulation S-K, Instruction 4 to Item 402(b). *See also,* SEC Interpretations, Item 402 of Regulation S-K — Executive Compensation (Last Update: Feb. 12, 2007), Q&A 3.04, *How does a company determine if it may omit disclosure of performance target levels or other factors or criteria under Instruction 4 to Item 402(b)?*

[26] Regulation S-K, Item 402(b)(2)(iv). *See also* Section II, A, 2 of Securities Act Release No. 8732A.

[27] SEC Interpretations, Item 402 of Regulation S-K — Executive Compensation (Last Update: Feb. 12, 2007), Q&A 3.01, *Is the guidance regarding Compensation and Discussion Analysis disclosure concerning option grants that is provided in Section II, A, 2 of Securities Act Release No. 8732A applicable to other forms of equity compensation?* (Yes.)

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ISSN 0148-8295

panies even offered up disclosures that indicated that they had re-evaluated these benchmark companies and had made changes to the group on a prospective basis (most applying the new group starting in 2007). Most disclosures even did a great job telling readers what level of compensation they targeted relative to these benchmark companies, i.e., seventy-fifth percentile or median.

Where I found some of the disclosures lacking was in telling readers how actual compensation paid stacked up against the benchmark companies. In other words, if a company said it targeted median levels of compensation versus the benchmark companies, and then discussed actual compensation decisions and amounts paid during the year, it did not always follow that up with a discussion of where the actual compensation paid to the NEOs put them relative to the benchmark companies and the targets they had disclosed.

Stock Ownership Guidelines

A number of companies disclosed that their executives were subject to stock ownership guidelines this past proxy season. However, the utility of these disclosures varied widely. Some companies simply stated that they had guidelines, that for the CEO they were 5x salary and for all the other NEOs they were 2x salary, that the NEOs were given five years to comply with the guidelines and that all NEOs were in compliance. What appeared to be missing was a discussion of the number of shares that equaled the salary multiple guideline, a discussion of when and how compliance with the guideline is reviewed, when the stock ownership guidelines first applied to each NEO, what counts towards the stock ownership guidelines, how many shares each NEO holds pursuant to the guidelines as of the last assessment date (if not last fiscal year end), and what happens if an executive fails to achieve the guideline within the prescribed time. One company that has such a robust disclosure concerning its executive stock ownership guidelines is Genworth Financial.[28]

Impact of Regulatory Compliance

Another area that had mixed results in the CD&A disclosures was the discussion of the impact, if any, of regulatory compliance on the company's compensation design and decisions. This would include compliance with §§162(m) and 409A,[29] accounting for equity awards, and any other regulatory requirement that might impact a company's decisions with respect to compensation for NEOs. For example, in the case of military contractors, the author has been told that the U.S. Government does not reimburse for the cost of certain types of equity awards, which might have an impact on the decision as to the type of equity awards granted to NEOs. By and large, to the extent the impact of regulatory compliance was discussed, the discussions seemed to echo those of the old Compensation Committee Reports, particularly when it came to the deductibility of compensation under §162(m). Perhaps, most companies do not place too much emphasis on regulatory requirements when deciding how to compensate their executives or perhaps they view regulatory compliance as not having a "material" impact on compensation. That certainly would explain the generally sparse disclosures regarding these issues. However, one then might wonder why companies have shifted their long-term equity grants from being almost entirely in the form of stock options just several years ago to being more a mix of stock options, performance shares and time-based restricted stock today. Several companies did address this shift and pointed to the implementation of mandatory stock option expensing as one factor that went into their decision to shift the form of their equity incentives.

The 5Ws (+H)

The one thing that became apparent in reviewing compensation disclosures under the Final Rules was that some companies were not using the 5Ws (+H) when crafting their disclosures. The 5Ws (+H) are: who, what, when, where, and why (plus how). If companies keep the 5Ws (+H) in mind as they draft and review their compensation disclosures, they can ensure their disclosures will have meaning to their readers (ostensibly, the company's shareholders). As John White, the SEC's Director of the Division of Corporation Finance, said, "Corporation Finance will be looking to see if you've [(public companies)] answered the 'how' (as Chairman Cox said) and the 'why' questions rather than merely the 'who, what, where and when.' "[30]

THE COMPENSATION TABLES — GENERALLY

To start with, I was surprised to see that not all companies titled their compensation tables correctly. The instructions from the Final Rules indicate that the fiscal year being covered by the table should be included in the table's title.[31] Granted, this is a minor point, and given that the disclosures only were required to cover the last fiscal year this go round, one that may not have had any material impact. However,

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[28] *See* Genworth Financial, Inc.'s proxy filed Apr. 3, 2007, p. 27.

[29] Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

[30] Speech by SEC Staff (John W. White, Director, Division of Corporation Finance): *Keeping the Promises of Leadership and Teamwork: The 2007 Proxy Season and Executive Compensation Disclosures*, May 3, 2007, *available at* http://www.sec.gov/news/speech/2007/spch050307jww.htm.

[31] Regulation S-K, Instruction to Item 402. "Specify the applicable fiscal year in the title to each table required under this Item which calls for disclosure as of or for a completed fiscal year."

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ISSN 0148-8295

this minor technical point is being raised to illustrate that there were provisions in the Final Rules which were not followed during this first proxy season. Additionally, by raising this issue companies and their advisors will be cognizant of it next year as they craft their compensation disclosures.

Many companies did what they had done in the past and presented the tables right after the CD&A (the main narrative disclosure), without any transition. However, some companies did provide lead-ins to the tables that explained the tables under the Final Rules and explained things that readers should know about the information presented in the table. Most often, these lead-ins were the required narratives for the tables, just switched to precede the tables, which generally proved to be very effective in setting the stage to allow a reader to better understand what was disclosed in the table.[32]

One issue that sprang to mind in reviewing the compensation disclosure tables is that companies often deleted columns (as permitted by the Final Rules if no information in that column was to be presented[33]) without letting readers know that they had done so and the reason for the deletion. Including such information makes it easier for the reader to understand the disclosures, so I hope more companies do that in next year's proxy disclosures.

A related issue had to do with companies adding columns to tables. This is not prohibited under the Final Rules, but it often was difficult to identify these supplemental, non-required columns in tables. So again, while not required, companies should consider clearly indicating when they add a supplemental column to a table and giving their rationale for doing so.

SUMMARY COMPENSATION TABLE

There are several issues concerning the Summary Compensation Table. First, some companies appeared to have a disconnect between their CD&A and their Summary Compensation Table related to their annual bonus. Under the final rules, it appears that if a plan has pre-established performance goals (as would be the case with an §162(m) qualified plan), it would meet the definition of a Non-Equity Incentive Plan.[34] As such, you would expect to see the annual bonus disclosed in the Non-Equity Incentive Compensation Plan Compensation column of the Summary Compensation Table and not in the Bonus column.

The author's experience has been that this portion of the new compensation disclosure rules confuses people and does not comport with how companies, shareholders, executives or boards generally think about an annual bonus. But, that should not be the basis for a company to overlook the plain language of the rules and disclose such an annual bonus in the Bonus column, even if a footnote is added that describes the disclosure. To do so subverts the comparability of compensation disclosures of different companies under the new rules. Consequently, the Final Rules in this regard should be revised.

For next year, in order to comply with investor expectations and the way in which companies think about annual bonuses (even those that qualify as Non-Equity Incentive Plan Compensation), the SEC should require that all annual bonuses be disclosed in the Bonus column with a footnote describing the process for setting the amount of compensation awarded and whether the bonus being paid will qualify for the performance-based compensation exemption to §162(m)'s $1 million limit on the deductibility of compensation paid by public companies.

Second, the Stock and Option Awards columns have caused some confusion and displeasure under the Final Rules. Under the Initial Final Rules, these columns would have only included the grant date fair value for stock and option awards granted during the last fiscal year.[35] Then, the SEC changed this in the Amended Rules to require that these columns instead reflect the amount recognized under the accounting rules for the last fiscal year for *all* outstanding stock and option awards, while the grant date fair value would be reported in the Grants of Plan-Based Awards Table.[36]

Some investors were not happy with this change and decried the lack of notice and timing of the change.[37] Meanwhile, once the data started coming out in the tables, some media sources began to calculate ''total pay'' differently than what is reported in the ''Total Compensation'' column of the Summary Compensation Table.[38] This caused a bit of confusion and brought into question the utility of reporting a ''Total Compensation'' amount for NEOs if the media will simply ignore it anyway.

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[32] *See* the proxy statements of: Aetna Inc., filed Mar. 19, 2007, p. 38; American International Group, Inc., filed Apr. 6, 2007, pp. 35-45; Sprint Nextel Corporation, filed Apr. 9, 2007; Wachovia Corporation, Mar. 9, 2007, pp. 35-47.

[33] Regulation S-K, Instruction 5 to Item 402(a)(3).

[34] Regulation S-K, Item 402(a)(6)(iii). ''A non-equity incentive plan is an incentive plan or portion of an incentive plan that is not an equity incentive plan,'' and an ''incentive plan means any plan providing compensation intended to serve as incentive for performance to occur over a specified period, whether such performance is measured by reference to financial performance of the registrant or an affiliate, the registrant's stock price, or any other performance measure.''

[35] Initial Final Rule, Regulation S-K, Item 402(c)(2)(v) and (vi).

[36] Amended Rules, Regulation S-K, Item 42(c)(2)(v) and (vi).

[37] Letter dated Jan. 16, 2007, from John C. Wilcox, Sr. Vice President, Head of Corporate Governance, Teachers Insurance and Annuity Association of America College Retirement Equities Fund, to the SEC (http://www.sec.gov/rules/proposed/s70306/s70306-788.pdf); Letter dated Jan. 16, 2007, from Jack Ehnes, Chief Executive Officer, California State Teachers' Retirement System, to the SEC (http://www.sec.gov/rules/proposed/s70306/s70306-789.pdf); Letter dated Jan. 25, 2007, from Jeff Mahoney, General Counsel, Council of Institutional Investors, to the SEC (http://www.sec.gov/rules/proposed/s70306/s70306-799.pdf).

[38] See Kirkland & Ellis LLP's Alert, *The Media and Executive Compensation Disclosures*, Apr. 2007, describing the Associated Press' methodology for calculating ''total pay.''

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ISSN 0148-8295

For next year, if the SEC wanted to limit these types of issues, it could require the full grant date fair value to be included in the Stock and Option Award columns of the Summary Compensation Table, along with a footnote that details the full accounting expense for the last fiscal year for all outstanding equity awards. The SEC should then only require compensation to be disclosed once in the Summary Compensation Table. Thus, if an executive earns a bonus that gets paid in stock, it should be included in the Bonus column with a footnote indicating the grant date fair value of the shares paid, and nothing should be disclosed in the Stock Award column.

Another issue with the Stock and Option Award columns is the requirement in the Final Rules to cite the material assumptions used for determining the grant date fair value.[39] Technically, the Final Rules require a cite to the assumptions used for all outstanding awards for which a company recognized an accounting expense during the last fiscal year.[40] As a result of the Amended Rules in December, this could include a number of years' worth of awards. Some companies simply cited their most recent financial footnotes, and those typically only covered the past three years. If a company had any awards granted beyond that time period, the cite would not have captured the assumptions for the awards granted before the three-year period of assumptions detailed in their most recent financial statements. Next year, companies should ensure that they cite to a sufficient number of years of notes to their financial statements to ensure they cover all material assumptions for awards that were outstanding during any part of the last fiscal year.

Another area that proved troublesome with the Summary Compensation Table was the explanations (or, more accurately, the lack of any explanation) of the amount in the Non-Equity Incentive Plan Compensation column. Some companies made it easy for readers to see what the amounts disclosed in the column were composed of, using a sub-table in the footnotes to detail the different elements included, e.g., annual bonus, long-term incentive plan payouts, etc. Giving this information in a strictly narrative footnote didn't seem to be quite as effective.

The All Other Compensation column also proved to be a challenge for figuring out the best way to provide the required footnote disclosure. Some companies simply used a narrative footnote, which complies with the Final Rules, but just isn't as easy to get into as a sub-table. Among those companies that used sub-tables in their footnote disclosure, there seemed to be two main styles. One style was to simply include a single sub-table, listing all the NEOs and all the elements that comprised their All Other Compensation. The other style was to take a two table approach along the lines of the required footnote disclosures. The first sub-table included all the NEOs and then the required groups of compensation elements, including perquisites. Then, another sub-table was included to detail amounts disclosed in the perquisites column of the first sub-table.

Finally, the Total Compensation column created some issues. As mentioned above, there were some investors that were upset at the issuance and timing of the Amended Rules, and who found the way "Total Compensation" is calculated under the Final Rules to be less than optimal. Some media outlets also disregarded the figures disclosed in the Total Compensation column in favor of their own methodology, which generally took the grant date fair value for stock and option awards under the Grants of Plan-Based Awards Table rather than the full accounting expense recognized for all outstanding stock and option awards during the last fiscal years.[41]

The SEC will launch a program to allow investors, the media, and other interested parties to calculate their own totals of compensation.[42] This program was demonstrated by the SEC Chairman in the same speech in which he discussed the readability of CD&As.[43] Unfortunately, while the XBRL (extensible business reporting language[44]) project will help investors calculate total compensation their own way, it may cause a few problems as well unless the final version irons out a few rough spots.[45] In particular, one problem is how things would get totaled if an executive decided to take compensation otherwise reported in the Summary Compensation Table in the form of stock or options. In such a case, the award would be reported in the Grants of Plan-Based Awards Table and show a grant-date fair value. This could (and has) led those who calculate their own version of total compensation to make some mistakes if they simply take the numbers reported in the tables, i.e., taking the equity grant information from the Grants of Plan Based Awards Table and everything else from the Summary Compensation Table. Both Yahoo and Leggett & Platt experienced this problem when the footnotes disclosing that their executives had taken equity in lieu of other compensation reported in their Summary Compensation Tables were missed by the media in totaling up compensation for their executives.[46]

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[39] Regulation S-K, Instruction 1 to Item 402(c)(2)(v) and (vi).

[40] *Id.*

[41] *See* Kirkland & Ellis LLP's Alert, *The Media and Executive Compensation Disclosures*, Apr. 2007, describing the Associated Press' methodology for calculating "total pay."

[42] Speech by SEC Chairman Christopher Cox: *Closing Remark to the Second Annual Corporate Governance Summit* (Mar. 23, 2007).

[43] *Id.*

[44] For more information about XBRL, see the website of the non-profit entity that controls this standard, XBRL International, at www.xbrl.org

[45] Letter dated Apr. 23, 2007, from Ernest C. Jett, Senior Vice President, General Counsel & Secretary, Leggett & Platt Incorporated, to the SEC (http://www.sec.gov/rules/proposed/s70306/s70306-834.pdf).

[46] *Id.*, The Associated Press, *Correction: Yahoo-Executive Compensation*, May 2, 2007.

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ISSN 0148-8295

GRANTS OF PLAN-BASED AWARDS TABLE

A number of companies added supplemental columns to the Grants of Plan-Based Award Table (GPBAT) that made it easier to understand their disclosures. The column that helped the most was one that was often titled "Award Type" or something similar. In this column, for each award made, as the titled suggests, the company indicated the type of award, i.e., restricted stock, restricted stock units, stock options, stock appreciation rights, and long-term cash incentive award. Some companies then went a bit further and gave an indication of the reason for the award, i.e., retention award, hire-on grant, annual grant, special grant/bonus, elected equity, etc.

A few companies also re-arranged the columns that made up this table and did not follow the required placement for the supplemental columns (date action taken to approve award, and closing stock price on the date of grant) that are required to be included in certain circumstances.

According to Salary.com, a group of about 140 companies placed all their NEOs' awards on a single line in the GPBAT.[47] This made it difficult, if not impossible, to gather the information for each award that shareholders should have been able to see had each award been presented on a separate line. Of the 140 companies that reported awards on a single line, Salary.com was unable to resolve the grants of about 30 companies.[48]

For next year, the SEC should clarify when a grant of equity earned in a prior year should be disclosed, e.g., an annual bonus earned in 2007 and paid, in stock, in 2008. Hopefully the SEC will permit the stock award to be disclosed with the compensation disclosure covering 2007 even though the stock was not granted until 2008. Investors, boards and executives all think of such stock awards as part of the 2007 compensation for the executive, not as 2008 compensation. So to better align with the expectations of the users of the required compensation disclosures, the disclosure rules should be revised in this area.

Another issue that the SEC should address relative to bonuses is how companies should disclose §162(m) bonus pool plans. Under these plans, companies set a performance metric that generates a large award or a large pool with a specified percent going to each NEO. After the year (the performance period), the companies assess the performance achieved under these §162(m) bonus pool metrics as well as under the metrics communicated to the NEOs. Companies then typically communicate other matters and goals that they will consider when finalizing the ultimate amount to be paid under such awards. Some companies disclosed the large bonus pool maximums while others chose to disclose the maximum communicated to the NEOs, even though their plan would have permitted these amounts to be increased, i.e., from a §162(m) perspective, the maximum §162(m) bonus amount ends up being reduced *less* than it otherwise would have been, resulting in a *larger* award.

NARRATIVE DISCLOSURE TO SCT AND GPBAT

This required narrative is intended to help supplement and explain the SCT and GPBAT.[49] The Final Rules indicate that companies need to discuss the material terms of employment contracts and other arrangements with NEOs.[50]

This narrative section also must explain the amount of salary and bonus in proportion to total compensation.[51] While a few companies accomplished this solely through a narrative, most companies effectively used a chart or graph to explore the relationship between salary, bonus, and total compensation.

OUTSTANDING EQUITY AWARDS AT FISCAL YEAR END TABLE

Most companies complied well with the Outstanding Equity Awards at Fiscal Year End Table requirements. Some companies enhanced the table for readers. Some included totals for each NEO of the various outstanding equity awards, while others included a column that showed the spread of outstanding stock options as of fiscal year end.

One issue related to this table that the SEC should address before next proxy season is related to the disclosure of vested restricted stock units (RSUs). The SEC should mandate that vested RSUs should continue to be disclosed in the Outstanding Equity Awards at Fiscal Year End Table until they ultimately are paid out in shares. Additionally, the SEC should indicate that vested RSUs should not be disclosed in the Non-Qualified Deferred Compensation Table, because doing so confuses readers and eliminates a key disclosure concerning the equity holdings of NEOs.

OPTION EXERCISES AND STOCK VESTED TABLE

Again, the disclosures generally were right on the money with the Option Exercises and Stock Vested Table. However, a few companies did go above and beyond and added totals by NEO when multiple awards were exercised or vested.

PENSION BENEFITS TABLE

The disclosures for the Pension Benefits Table were fairly straight-forward. However, some of the accompanying narrative was not and it took a little while to

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[47] Based on the author's conversation with Josh Lurie, Vice President Executive Compensation & Business Development, Salary.com on Apr. 27, 2007.

[48] *Id.*

[49] Regulation S-K, Item 402(e).

[50] *Id.*

[51] *Id.*

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ISSN 0148-8295

get used to it. Some companies that disclosed multiple plans also included reader-friendly totals by NEO to allow readers to easily see the total pension benefit a NEO would receive.

NONQUALIFIED DEFERRED COMPENSATION TABLE

Here again, some companies that had multiple deferred compensation plans included totals by NEO which helped increase the readability of the table.

POTENTIAL PAYMENTS UPON TERMINATION OR CHANGE-IN-CONTROL

The Final Rules do not require companies to use tables in disclosing potential payments upon termination or a change-in-control for NEOs.[52] However, the preamble to the Initial Final Rules encourages companies to use tables.[53]

Most companies did use tables to help disclose and explain their potential payments upon termination or change-in-control. However, a few companies did not use tables and instead used a pure narrative to explain such amounts. Unfortunately, the pure narrative format can be difficult to follow and use. Additionally, a question exists (at least in the author's mind) as to whether a company using a pure narrative disclosure format can be found to have complied with the plain English disclosure requirements (which do indicate that charts and graphs should be used in lieu of lengthy narrative to more easily convey information to readers[54]). Hopefully all companies will use tables with this disclosure requirement next proxy season.

While most companies used tables, some stopped short of giving truly useful information to readers. Some of these companies simply gave a single, lump-sum number for each termination event, while others gave numbers for each component but did not total up all the components and report such total in their table(s).

For next proxy season, the SEC should address whether giving a single number for each termination event, without an explanation of how such numbers were developed, is sufficient. The SEC also might want to consider whether the potential payments should include vested amounts (they should if the SEC wants companies' disclosures in this area to give readers a complete picture of what an NEO stands to receive upon a change-in-control).

Finally, the SEC should consider whether some type of minimum tabular disclosure for this information should be required. Such tabular disclosure should be limited to four events: (1) Voluntary Termination of Employment, both (a) before a Change-in-Control, and (b) after a Change-in-Control, and (2) Involuntary Termination of Employment, both (a) before a Change-in-Control, and (b) after a Change-in-Control. In requiring such a tabular disclosure, the SEC could consider requiring standard categories for companies to use along with an "All Other" category like in the Summary Compensation Table. The All Other category could be used as a catch-all for items that do not fit into the standard categories, and could trigger footnote disclosures to explain the amounts included in the column if certain thresholds are exceeded or met (similar to what is done for the All Other Compensation column in the Summary Compensation Table).

DIRECTORS COMPENSATION TABLE

Generally, the disclosures for this table complied with the rules. However, a few companies made their disclosures more useful by adding footnotes to the cash fees column that detailed the components of the cash being paid to each director.

Additionally, some companies included sub-tables that detailed the outstanding equity awards at fiscal year end, as well as the grant date fair value of such awards, and the expense recognized for such awards during the past fiscal year.

One issue that the Final Rules raised related to having to disclose the compensation of anyone who served as a director during the last fiscal year.[55] As a result, companies were required to include both current and former directors (who acted as directors during the last fiscal year) in the Director Compensation Table.[56] Some companies used a single table and simply grouped the directors into two groups: current and former. Other companies used two separate tables, one for current directors and another for former directors.

Another interesting wrinkle with the Directors Compensation Table involves the treatment of non-NEO executives who are directors. In such cases, these individuals do not need to have their compensation as an employee also disclosed if they receive no additional compensation for service as a director and a footnote or the narrative disclosure indicates that fact.[57]

BEST PRACTICES

The review of the compensation disclosures of the Fortune 100 companies that had filed a proxy under

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[52] Regulation S-K, Item 402(j).

[53] Initial Final Rules, Section VI.

[54] *Id.*

[55] Regulation S-K, Item 402(k).

[56] *Id. See also* SEC Interpretations, Item 402 of Regulation S-K — Executive Compensation (Last Update: Feb. 12, 2007), Q&A 12.01, *Is director compensation disclosure required under Item 402(k) of Regulation S-K for a person who served as a director for part of the last completed fiscal year, even if the person was no longer a director at the end of the last completed fiscal year?* (Yes)

[57] SEC Interpretations, Item 402 of Regulation S-K — Executive Compensation (Last Update: Feb. 12, 2007), Interpretative Responses Regarding Particular Situations, §12.02.

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ISSN 0148-8295

the new rules by April 14, 2007, revealed several best practices under the Final Rules:

- Use a table to disclose the performance goals and actual performance achieved for compensation plans in the CD&A[58]
- Use a table and supporting narrative disclosure in the CD&A to detail stock ownership guidelines, including what the guidelines are, the number of shares and date calculated for the guidelines, the number of shares actually owned by each NEO, how much time is given to attain the guideline amount and where each NEO is within such period, and what counts for purposes of the guidelines[59]
- Use a sub-table to the Summary Compensation Table that details the components of Non-Equity Incentive Plan Compensation amounts[60]
- Use one or more sub-tables to the Summary Compensation Table that detail the components of All Other Compensation[61]
- Include a description of the various grants detailed in the Grants of Plan-Based Awards Table (an Award Type column)[62]
- Whenever multiple lines of data are presented for an NEO, if appropriate, also present a total of such lines of data to aid readers[63]
- Use charts and/or tables to explain termination or change-in-control payments and benefits[64]
- Better explain the compensation amounts disclosed for Directors.[65]

CONCLUSION

This first proxy season under the Final Rules was a learning experience for all. The SEC Staff already has announced that it is reviewing the compensation disclosures that were filed under the Final Rules to see if it should recommend that any of the Final Rules need to be revised, or at least tweaked through the issuance of some additional guidance.[66] The SEC Staff's review and analysis of the compensation disclosures during this first season likely will be a ''must read'' for companies and their advisors. Hopefully it will offer some guidance as to what the SEC considers ''good disclosures'' as well as those that may ''need improvement.''

The disclosures this first proxy season overall were much improved compared to those under the old compensation disclosure rules. The real trick will be for the SEC to convince issuers to fully and voluntarily comply with the Final Rules. This is very similar to the situation faced by the IRS in trying to get individuals and businesses to voluntarily comply with the Internal Revenue Code. Let's hope the SEC does not have as many problems in trying to gain voluntary compliance (with both the letter and spirit of the rules) as the IRS.

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[58] *See* the proxy statements of: The Allstate Corporation, filed Apr. 2, 2007, p. 23; Marathon Oil Corporation, filed Mar. 13, 2007, p. 47.

[59] *See* the proxy statements of: Genworth Financial, Inc., filed Apr. 3, 2007, p. 27; The Dow Chemical Corporation, filed Mar. 23, 2007, p. 23.

[60] *See* the proxy statement of Aetna Inc., filed Mar. 19, 2007, p. 40.

[61] *See* the proxy statements of: Aetna Inc., filed Mar. 19, 2007, p. 41; Sprint Nextel Corporation, filed Apr. 9, 2007, p. 36; Target Corporation, filed Apr. 9, 2007, p. 27.

[62] *See* the proxy statements of: CVS/Caremark Corporation, filed Apr. 4, 2007, p. 39; The Allstate Corporation, filed Apr. 2, 2007, p. 32.

[63] *See* the proxy statements of: The Allstate Corporation, filed Apr. 4, 2007, p. 36; JPMorgan Chase & Co., filed Mar. 30, 2007, p. 20.

[64] *See* the proxy statements of: Weyerhaeuser Company, filed Mar. 9, 2007, p. 38; Motorola, Inc., filed Mar. 15, 2007, p. 53.

[65] *See* the proxy statements of: Raytheon Company, filed Mar. 11, 2007, p. 11; Merrill Lynch & Co., filed Mar. 16, 2007, p. 58.

[66] Speech by SEC Staff (John W. White, Director, Division of Corporation Finance): *Keeping the Promises of Leadership and Teamwork: The 2007 Proxy Season and Executive Compensation Disclosures*, May 3, 2007, *available at* http://www.sec.gov/news/speech/2007/spch050307jww.htm.

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ISSN 0148-8295