Try, Try Again: Implications of Last Season's Proxy Disclosures and SEC Comments for 2008 Proxy Disclosures

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EXEQUITY

Independent Board and Management Advisors

Speaker and Relevant Publications

- Speaker
  - Edward Hauder – edward.hauder@exqty or (847) 996-3990
- Relevant Publications – *available on www.exqty.com under "Reference Materials"*
  - **Preparing The New Compensation Discussion And Analysis,** Edward Hauder and Mike Sorensen, The Corporate Board, March/April 2007, pp. 10-15
  - **Alert: SEC Amends Proxy Disclosure Rules to Align Better With FAS 123R**, Edward Hauder and Mike Sorensen (December 2006)
  - **PULSE Study: Readability of CD&As Filed Under the New Proxy Disclosure Rules**, Edward Hauder (April 9, 2007)
  - **The New Executive and Director Compensation Proxy Disclosures – An Initial Analysis of the Recently Completed First Proxy Season Under the New Rules**, Edward Hauder, BNA's Tax Memorandum, Vol. 48, No. 15, July 23, 2007.
  - **The New Proxy Disclosure Tables: What Goes Where?**, Edward Hauder, The Bureau of National Affairs' Benefits Practice Center, Executive Compensation Library, Journal Reports: Law and Policy (November 2006; Updated February 2007)
  - **The Final Proxy Disclosure Rules: Implications and Issues**, Edward Hauder, BNA's Tax Management Compensation Planning Journal, Vol. 34, No. 11, November 3, 2006, pp. 275-299.

Agenda

- SEC Report and Comments
- The Seven Deadly Sins of Proxy Disclosure
- Best Practices for Proxy Disclosure
- Implications for 2008

SEC Report and Comments

- SEC issued comment letters to approximately 350 companies
  - Issued During August 2007, response deadline of September 21, 2007, and several companies requested and received extensions
  - Covered companies in a wide range of industries and market caps
  - Comments addressed the companies' disclosures under the new executive and director compensation rules
- SEC comments in these comment letters appeared to focus on the CD&A, and covered the following areas:
  - **Compensation Philosophy**
    - Explain and place in context why the company chose to pay each element of compensation
  - **Role of Outside Advisors**
    - Disclose the material elements of the instructions or directions the compensation committee gave to the compensation consultant(s)
    - If both the compensation committee and management retained their own consultants, clarify the duties of each consultant and their role in establishing compensation for the NEOs, and identify each consultant by name

SEC Report and Comments

- **Peer Groups/Comparator Groups/Benchmarking**
  - Expand disclosure of targeted percentiles to explain why/how the targets were selected
  - Disclose how actual elements of compensation compare to targeted amounts against the peer group/comparator group
  - Provide the names of all peer group/comparator group companies
  - If using a pre-established compensation survey, detail the names of the participating companies
- **Performance Targets**
  - Expand disclosure to include how individual performance of the NEOs was taken into account by the compensation committee and the effect it had on each element of compensation which individual performance was considered
  - Disclose the performance goals for the current year
  - Discuss the weight given to each performance factor or goal and how performance affects the compensation awarded
  - Expand disclosures to include performance targets, and if you believe that the disclosure of the targets would cause harm and be excluded under Instruction 4 to Item 402(b) of Regulation S-K, provide on a supplemental basis a detailed explanation for such conclusion

SEC Report and Comments

- **Performance Targets (continued…)**
  - Note any time that the compensation committee used its discretion to adjust compensation paid and note where adjustments affected an individual NEO rather than the group as a whole
- **Regulatory Impact on Compensation**
  - Explain how tax, accounting and Code Section 162(m) implications and considerations impact compensation decisions, design and programs
- **Differences in NEO Compensation**
  - Explain why CEO’s compensation is so much higher than the other NEOs
  - Disclose the material terms of the CEO’s employment agreement and analyze why the agreement was designed and structured to provide what it does
  - Clarify whether the compensation committee considered other factors in setting compensation for the NEOs other than the CEO
- **Severance and Change-in-Control**
  - Provide additional detail on the Change-in-Control triggers
  - Explain how the severance, termination and/or Change-in-Control terms were the result of negotiations or the result of an evaluation of benefits provided by peer/comparator companies
  - Add a total for each NEO

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SEC Report and Comments

- **Director Compensation**
  - Disclose all assumptions made in making the valuation of stock and option awards shown in the Director Compensation Table
  - Describe why the Chairman's fees, stock awards and total compensation are so much greater than the other board members
- **Required Tabular Disclosures**
  - Some minor comments on the tabular disclosures
  - Appears a few companies failed to follow the instructions, and the SEC provided a comment where they saw the rules had not been followed
- **Related Party Transactions**
  - A few comments asking companies to disclose and/or clarify issues related to their related party transactions

SEC Report and Comments

- SEC Report, "Staff Observations in the Review of Executive Compensation Disclosure"
  - Issued October 10, 2007
  - Covered the SEC's observations on the 350 companies whose executive compensation disclosures were reviewed
  - Two principal themes from the Report:
    - CD&As need to be focused on **how** and **why** a company arrives at specific executive compensation decisions and policies, *e.g.*, they need more ***analysis***
      - The focus should be on helping the reader understand the basis and the context for granting different types and amounts of executive compensation
    - The **manner** of presentation matters – in particular, using plain English and organizing tabular and graphical information in a way that helps the reader understand a company's disclosure

SEC Report and Comments

- SEC Report Observations
  - **Manner of Presentation**
    - SEC suggested ways companies could improve
    - Examples:
      - Making some items of disclosure more prominent;
      - Emphasize material information;
      - Emphasizing in CD&A **how** and **why** they established compensation levels
  - **Format**
    - Relatively consistent among 350 companies reviewed
    - CD&A – a narrative overview, should come first
    - Approximately two-thirds of companies included charts, tables and graphs not specifically required – found almost all to be helpful; suggest include a total in the termination or CIC disclosure tables
    - If include an Alternative Summary Compensation Table, should explain differences between it and the required tables

SEC Report and Comments

- **Clarity**
  - "We found that, in several instances, companies made a good faith effort to provide clear and understandable disclosure, but fell short of full compliance with the underlying disclosure requirements"
  - Careful drafting consistent with plain English principles could result in shorter, more concise and effective discussion that complies with the rules
- **CD&A**
  - In responding to the principles-based disclosure requirements, companies must analyze the material factors underlying their compensation policies and decisions
  - Asked many companies to enhance their analyses of compensation policies and discussions, including how they determined the amounts of specific compensation elements
- **Compensation philosophies and decision mechanics**
  - Asked a substantial number of companies to refocus their CD&As on the substance of their compensation decisions and to disclose how they analyzed information and why their analyses resulted in the compensation they paid
  - Asked a significant number of companies to discuss the extent to which the amounts paid or awarded under each compensation element affected the decisions they made regarding amounts they paid or awarded under other elements

SEC Report and Comments

- **Differences in compensation policies and decisions**
  - Where a company's disclosure led the SEC to believe that its policies and decisions for individual named executive officers may be materially different, the SEC reminded the company of the Commission's statement concerning identification of material differences in compensation policies and decisions for individual NEOs
- **Performance targets**
  - SEC found that a substantial number of companies alluded to using or disclosed that they used corporate and individual performance targets to set compensation
  - Issued more comments regarding performance targets than any other disclosure topic reviewed
  - "In making these comments, we do not seek to require companies to defend what may properly be subjective assessments in terms of purely objective or quantitative criteria, but rather only to clearly lay out the way that qualitative inputs are ultimately translated into objective pay determinations."
  - Where companies did not disclose actual targets, but did attempt to address difficulty of achieving such targets, the SEC often sought more specific disclosure that would enhance investor understanding of the difficulty or likelihood
  - SEC indicates in some circumstances companies may need to discuss prior and current year performance targets to place its disclosure in context or make understandable

SEC Report and Comments

- **Benchmarks**
  - "If a company uses benchmarking, and it is material to its compensation policies and decisions, Item 402 requires it to "identify the benchmark and, if applicable, its components (including component companies)."
  - SEC asked a substantial number of companies to provide a more detailed explanation of how they used comparative compensation information and how that comparison affected compensation decisions
- **Change-in-control and termination arrangements**
  - The SEC found that a significant number of companies could enhance their CD&A by discussing and analyzing decisions regarding CIC and termination arrangements with their NEOs
  - SEC asked a number of companies to disclose why they structured their CIC and termination payment provisions as they did and to discuss how potential payments and benefits under such arrangements impacted decisions under other compensation elements
- **Executive and Director Compensation Tables**
  - The SEC did not detect any common themes among the companies reviewed

SEC Report and Comments

- **Compensation Committee Report**
  - The SEC found that a number of companies did not fully comply with the Compensation Committee Report requirements
- **Related Person Transaction Disclosure**
  - The SEC had relatively few comments on related person transaction disclosure
  - SEC did ask a number of companies to provide a statement that their policies and procedures for review, approval, or ratification of related person transactions are in writing, and, if not, to explain how they evidence their policies and procedures
- **Corporate Governance**
  - The SEC comments were primarily focused on who was involved in making compensation decisions
  - Where companies indicated that their PEOs had a role in the compensation decision-making process, the SEC asked them to describe his or her role
  - The SEC asked a number of companies to more specifically disclose the nature and scope of a consultant's assignment and material instructions the company gave it

The Seven Deadly Sins of Proxy Disclosure

1. Not Providing Adequate Analysis
2. Failing to Explain "Why?" and "How?"
3. Playing "Hide the Ball"
4. Writing Too Much/Too Little
5. Disconnect Between CD&A and Proxy Tables
6. Not Making Disclosures Reader Friendly
7. Not Following the Rules

Best Practices for Proxy Disclosure

- Best Practice for Proxy Disclosures
  - **Chart/Table in CD&A for Overview of Elements of Compensation** – using such a chart/table makes it possible to quickly detail the elements of compensation for NEOs, the definition/description of each element, and the reason/purpose (the "how" and "why") these elements are used
    - Used in proxies of: Aflac, Ameriprise Financial, Gannett, General Cable and Genuine Parts
  - **Chart/Table for Performance Goals** – using a chart/table to disclose the company's performance goals and actual performance achieved for compensation plans in the CD&A makes it easier for readers to understand the performance metrics
    - Used in proxies of: Allstate and Marathon Oil
  - **Chart/Table for Stock Ownership Guidelines** – using such a chart/table along with supporting narrative disclosure in the CD&A makes it easier for readers to understand your stock ownership guidelines, especially if the table details the stock ownership 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. Can use a similar approach for director stock ownership guidelines.
    - Used in proxies of: Genworth Financial and Dow Chemical

Best Practices for Proxy Disclosure

  - **Sub-Tables to Summary Compensation Table for All Other Compensation** – using one or more sub-tables to detail the various components of All Other Compensation makes it easier for readers to understand your disclosures
    - Used in proxies of: Aetna, Sprint Nextel, and Target
  - **Description of Grant in Grants of Plan-Based Awards Table** – including a column (perhaps titled "Award Type") in the Grants of Plan-Based Awards Table that describes the various grants included (*e.g.,* performance share award, restricted stock, stock option, stock appreciation right) makes it easier for readers to understand the disclosures included in that table
    - Used in proxies of: Allstate and CVS/Caremark
  - **Totaling Multiple Lines of Information by NEO**– whenever multiple lines of data are presented for an NEO, if appropriate, also present a total of such lines of data to aid readers in better understanding the whole disclosure
    - Used on proxies of: Allstate and JPMorgan Chase

Best Practices for Proxy Disclosure

- **Chart/Table for Termination and Change-in-Control Payments and Benefits** – using a table to disclose such payments and benefits permits readers to more easily comprehend the disclosure, especially if, as SEC Comments and the SEC Report suggest, totals for the various termination events are also included by NEO
  - Used in proxies of: Motorola and Weyerhaeuser
- **Better Director Compensation Disclosure** – by expanding the director disclosures, both tabular and narrative, to provide a more complete understanding of the director compensation program at the company, readers will benefit
  - Used in proxies of: Merrill Lynch and Raytheon

Implications for 2008

- The SEC's Report highlighted those disclosures that the SEC wants companies to improve on for next year
  - Key items include:
    - More **analysis** in the CD&A
    - Better disclosure around performance goals and targets
    - Presenting information in a way that makes it easy for readers to understand (not necessarily through narrative disclosure alone)
  - John White's recent speech suggested asking all parties involved in the disclosure process for a single page of bullets detailing the company's material elements of its compensation programs and decisions
- Disclosures under the new rules are not easy
- To prepare good disclosures takes time, patience, an attitude of openness, and access to the necessary compensation information