Fall 2007

Compensation Standards

A Quarterly Newsletter for Directors and Advisors about Executive Compensation Practices

Director Alert: SEC Focusing on Your CD&A

A few weeks ago, the SEC Staff began sending the first wave of comment letters on the executive compensation disclosures in 2007 proxy statements. Within the next few weeks, as many as 300 companies may receive comments. The comment letters will be followed this Fall with a Staff Report that will address what the Staff expects for the 2008 proxy season.

Because directors will need to start addressing many of the SEC's concerns *now,* we are devoting this entire issue to the most critical aspect of the SEC's focus—companies' failure to provide meaningful, critical analysis in the CD&A.

Understanding the SEC Comment Process

The comments come from a special Task Force formed within the SEC's Division of Corporation Finance. The Task Force consists of one lawyer from each of the Division's industry group offices and a handful of senior Staff members that are overseeing the review project. In general, it appears that companies are selected for review due to their large size—and not necessarily because their disclosures are more deficient than their peers.

The Staff gives approximately 30 calendar days from the date of the letter to file a response or to let the Staff know when the company will respond. In some cases, thirty days will not be sufficient for a company to conclude a thoughtful review of the comments, particularly where the changes impact the CD&A (which the compensation committee is responsible for reviewing), because the compensation committee should also review the comments and proposed response.

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To accomplish this, companies will likely either need to schedule a special compensation committee meeting during the 30-day period or inform the Staff (as soon as possible) as to when it will be able to respond (*e.g.*, shortly after the next regularly-scheduled compensation committee meeting). Historically, the Staff has been accommodating in granting extensions of time to respond to comments, so long as the company has a valid reason for requesting the extension and the length of time requested is reasonable. ■

How the SEC Is Focusing on Your CD&A–Particularly the "A"

Drafting the Compensation Discussion and Analysis (CD&A) was challenging in the 2007 proxy season, given the need to write the disclosure on a "clean slate" without the benefit of examples. It is obvious that companies struggled with the principles-based requirements of the CD&A, and more often than not the result was disclosure that was overly long, difficult to read and lacking in the required analysis of compensation practices and decisions.

The bottom line for directors—and others involved in preparing and reviewing your upcoming CD&A—is that failing to provide sufficient analysis in the CD&A means that a company is telling only part of the story, and the company is not complying with either the spirit or letter of the rule. This situation subjects the company—as well as its officers and directors—to potential SEC enforcement action or other shareholder litigation.

It is clear that—in the eyes of the SEC—a major disappointment of this year's proxy season was the widespread lack of analysis in the CD&A. By far the most significant concentration of the SEC's comments is on the CD&A—typically more than half of the comments raised—where the Staff is focusing on the need for more analysis of compensation practices and decisions. In some cases, the Staff makes very open-ended requests for further analysis. In other situations, the Staff focuses on particular aspects of the CD&A disclosure. The tone of these comments, which mostly repeat the rule's requirements, appear to reflect the Staff's view that companies should "try again" with their CD&A.

Many companies were inclined to present an inventory of compensation elements with only a cursory description of how each element is determined and how they relate to each other as a whole. Often, companies did not take the next step to explain how individual compensation decisions related to the company's specific compensation policies and their overall executive compensation program. In too many proxies, companies focused their analysis on the relationship of executive pay at the company to the pay at benchmark companies (which were not always identified). Little or no analysis was provided regarding the relationship between executive pay and the company's own compensation philosophy or policies, and how that was carried out by analyzing the compensation paid to the CEO in relation to other executives and employees.

As we noted in our Special Supplement to the September-October 2006 issue of *The Corporate Counsel* (available on the right side of CompensationStandards.com), the expectation was that the requirement for analysis in the CD&A would serve as a powerful new motivator for compensation committees to implement important tools for critically analyzing CEO and executive compensation and for CEOs to implement changes to make fixes where compensation had gotten "out of line." Unfortunately, in too many cases this past proxy season, companies sought to side-step the hard truths that meaningful analysis should reveal. It is clear from the comment letters that the SEC Staff is dead set on making companies put the "A" back into the CD&A. ■

How to Highlight the Analysis for the SEC—and Shareholders

The SEC's plain English rules encourage the use of descriptive headings and subheadings, and nowhere is a separate subheading needed more than in identifying the Analysis section of the CD&A. By providing the disclosure under its own caption, readers can easily identify and refer back to the analysis underlying the rest of the compensation disclosure. By contrast, "burying" the analysis or dispersing it throughout the CD&A will likely frustrate shareholders, upset the SEC Staff and make it difficult for the company to communicate its overall compensation message.

The meaningful, critical analysis that the SEC expects does not happen overnight, and companies should not wait until the first draft of the proxy statement. The compensation committee needs to focus on the necessity of articulating a rationale for compensation policies and individual compensation decisions, and companies must ensure that disclosure controls and procedures are in place to capture the rationale behind the decisions. Now more than ever, companies need to carefully consider—before decisions or plans are made—how each element of compensation will be analyzed in the proxy statement, and the compensation committee needs to take those considerations into account when it is making the decisions. ■

The SEC is Asking About the Committee's Use of Discretion

The Staff is honing in on disclosure concerning the use of discretion in setting compensation, and is seeking expanded disclosure about the scope of this discretion and its use by the compensation committee. Specifically, the Staff requests that the company disclose the extent to which the compensation committee has discretion, circumstances that would result in the use of discretion, the elements of compensation that are subject to adjustment and whether or not discretion has been exercised in setting pay for the NEOs.

In those circumstances where discretion was exercised when performance goals were not met, the Staff seeks disclosure of the factors considered by the compensation committee in determining awards on a discretionary basis. ■

How the SEC Seeks Enhanced Disclosure Regarding Performance Plans—And Targets

With roughly half of the larger companies failing to provide disclosure about specific performance target levels (presumably relying on the ability to withhold this information if it is competitively harmful), this is an area where the Staff almost uniformly raises comments. Without disclosure of the performance target levels, it can be very difficult for investors to assess the compensation payable, and the actual compensation paid, in the context of the company's pay-for-performance philosophy. Lack of disclosure about the performance metrics and specific target levels can also make the analysis in the CD&A more difficult, as concrete numbers necessary to demonstrate the effectiveness of its pay-for-performance program are absent.

Staff comments seek more disclosure in the CD&A about (i) how the company has tailored incentive awards around specific performance goals, (ii) how the company determines the amount and (iii) where applicable, the formula for each element of compensation. In many instances, the Staff notes that disclosure concerning performance-based compensation is difficult to understand. In some cases, the Staff suggests that the company should provide more insight into the factors considered by the compensation committee before awarding the performance-based compensation, including any historical analyses or correlations between historical bonus practices and the incentives set for the relevant fiscal year.

The Staff also requests a tabular presentation comparing actual results to targets, and in some cases, hypothetical examples as a means of demonstrating the operation of complex performance-based plans. ■

The SEC's Focus on Key Analytic Tools

Internal Pay Equity

One of the most common CD&A comments is that the company must make the CD&A sufficiently precise so as to identify material differences in compensation policies and decisions for individual NEOs.

Many of these comments focus on the size of compensation packages for individual NEOs—particularly the CEO—relative to the compensation paid to the other NEOs. The Staff requests an explanation of the reasons for differences in the amounts awarded to each of the NEOs. The Staff references Section II.B.1 of the adopting release as the basis for this comment. Some readers have wondered whether these comments may be establishing a materiality threshold for a company's disclosure—so that companies will now need to provide an explanation in the CD&A whenever there is a significant difference in total pay (say, for example, a 2-to-1 difference in the CEO's total compensation relative to the next most highly paid NEO).

The Staff also requests a specific discussion of how the compensation committee evaluates the internal pay relationship among its executives and others in the company in setting compensation. For example, the Staff asks whether the committee analyzes the multiple by which a CEO's compensation is greater than that of other specified employees.

The clear message here from the SEC Staff to compensation committees is that internal pay equity is a critical consideration for compensation committees when considering and setting executive pay. Such an internal analysis is also essential to provide perspective whenever the compensation committee considers or is presented with survey data or benchmarking against other companies. (See the extensive materials and guidance regarding internal pay equity provided on CompensationStandards.com.)

The SEC's Focus on Tally Sheets and Wealth Accumulation

In some comments, the Staff requests information as to how the compensation committee uses tally sheets, including whether the committee increased or decreased the amount of compensation awarded based on the tally sheet information. Tally sheets are an important tool for compensation committees. Companies should fully (and proudly) describe their use of tally sheets as a means of assessing the total compensation paid (and to be paid) to the CEO—and for explaining compensation decisions and the rationale for such decisions.

No tally sheet is complete without an accompanying wealth accumulation analysis. The SEC's comments asking whether—and how—companies factored in other elements of pay when determining severance and change-in-control compensation is an important reference to the fact that compensation committees need to be performing a wealth accumulation analysis when making compensation decisions—and providing that analysis in the CD&A. (For more on the importance of wealth accumulation analysis, see the guidance provided on CompensationStandards.com.)

Benchmarking and Surveys—SEC Says Address the Flaws

A surprisingly large number of the Staff's comments focus on benchmarking disclosures. Overall, it appears that the Staff is not satisfied with the disclosure about peer groups and the explanations about the relationship of NEO compensation to benchmarked percentiles. The comments seek identification of the actual peer companies benchmarked against and disclosure of where actual payments fell in relation to the targeted parameters.

But the real issue here is the over-reliance on benchmarking. There needs to be other meaningful analysis—like internal pay equity—to provide an offsetting reality check and to see if the company is getting away from its own philosophies and values. If all the compensation committee does is look to surveys without undertaking an internal pay equity analysis, this will need to be disclosed in the CD&A. (For a discussion of what's wrong with surveys and what compensation committees are expected to be doing now, see the *Benchmarking and Survey Use* section on CompensationStandards.com.) ■

What to Do Now

It should be clear from the above that directors will need to take a more active role now in making sure that the analysis that the SEC expects will, in fact, be provided in your upcoming proxy statement. Compensation committees need to start the process today to implement these significant changes to their disclosure (and their process). Those companies that are not yet utilizing tools like tally sheets, wealth accumulation analysis and internal pay equity need to take a serious look at what those tools may reveal—and then take necessary corrective actions. The SEC's expectations will be even higher this coming year—and it would not surprise us if the SEC (and institutional investors) single out some companies for enforcement and other actions.

Ongoing Guidance

Space constraints did not allow us to cover other key proxy disclosures that the SEC is now expecting. For example, companies will now need to provide a total "walkaway number" to show in one place the total amount (including already vested amounts) a departing CEO would receive as a result of termination. This new SEC position is covered in depth in the September-October issue of *The Corporate Executive*. (We would urge readers to obtain that issue and to keep abreast of the ongoing guidance that is being provided in the upcoming issues of *The Corporate Counsel* and *The Corporate Executive*.)

The Upcoming October 11 Executive Compensation Conference

Now that the SEC is targeting the failure of companies to provide meaningful "Analysis" in their CD&As, the upcoming 4th Annual Executive Compensation Conference has taken on heightened importance—particularly for directors (and their advisors). As a result, we are attaching the agenda for the upcoming Conference. Every director should take it in. Note that access to the Live Nationwide Video Webcast will also enable your fellow directors to have ongoing access to the tapes and materials of all the key sessions.

The 4th Annual Executive Compensation Conference: "Lessons Learned"

Necessary Compensation Fixes—Impacting Your Proxy Disclosures

HEIGHTENED IMPORTANCE: This major one-day conference has taken on heightened importance now that the SEC has targeted the failure of many companies to provide meaningful "Analysis" in their 2007 CD&As. For 2008, all eyes will be focused on the "Analysis" section of the CD&A and the need to address the *tools* that compensation committees are utilizing—and the resulting findings and actions. As a result, this Conference will be a "must" for anyone who has any role in setting/approving compensation or the preparation or review of proxy statements.

With **directors**—as well as **CEOs**, **lawyers**, and **consultants** who review or prepare this year's proxy disclosures—**about to face greater scrutiny and potential exposure than ever before**—attendance at this year's conference truly is a "must."

7:30 – 7:45 am — **Opening Address: "Lessons Learned"—John Olson**, *Gibson Dunn & Crutcher*

7:45 – 8:45 am — **"How Much? Rethinking Everything, Including Routine Grants, Post-Employment Provisions and More"—Sam Armacost**, Lead Director, Chevron Corporation; former CEO, Bank of America, will join key directors and top consultants who will speak with candor.

The Analytic Tools

The following panels will provide practical, first-hand guidance on dealing with the analytic tools that are now expected of compensation committees—and what to say about the tools in the CD&A "Analysis" section:

9:15 – 9:50 am — **"Breaking Down the Peer Benchmark Survey: Holes & Fixes"**
Benchmark surveys are flawed. Learn from insiders what companies should be doing.

9:50 – 10:30 am — **"How to Implement Internal Pay Equity"**
Learn from a Board Chair and others that have recently gone through the process.

11:00 – 11:30 am — **"Refining Tally Sheets: Fixes and Action Items"**—Key consultants will share their latest guidance.

11:30 – 12:15 pm — **"How to Implement a Wealth Accumulation Analysis—What to Do With Your Findings"**
Learn from a major company, Kellogg, that is going through the process of re-examining its compensation—applying wealth accumulation as a key analytic tool.

Key "Hot-Button" Fixes

Many companies are now re-examining and fixing "hot button" provisions. The following panels will address:

1:45 – 3:00 pm — **"The Consultants Speak: Straight Talk from the Top Experts"**
A "no holds barred" session with the top consultants.

3:30 – 4:00 pm — **"Drafting Effective Forfeiture and Clawback Provisions"**
Hear from Intel and McDonald's on how they recently implemented provisions with teeth.

4:00 – 4:30 pm — **"Fixing Post-Retirement and Severance Arrangements"**
Candid advice on necessary actions to return these provisions to their intended purpose.

4:30 – 4:45 pm — **"How to—and Why You Should—Unwind Tax Gross-Ups"**
Practical advice and candor from the trenches.

4:45 – 5:00 pm — **"Airplane Perks: The "Right" Way to Calculate Incremental Cost"**
Straight talk and guidance on getting these sensitive disclosures 'right.'

Do not delay. Register on CompensationStandards.com or return the enclosed form *today*.

Register Now!

With executive compensation now the "Number One" issue for boards, regulators and shareholders, this conference is a "must" for all directors and their advisors. **Note that registration rates are more than half-off for members of CompensationStandards.com.**

Where: You have two choices: you can attend the Conference at the San Francisco Marriott or via the Nationwide Live Video Webcast to desktops, boardrooms and conference rooms. [If you plan to attend in San Francisco, make your reservations for the Marriott as soon as possible online or call 800-266-9432. Be sure to mention the NASPP/Executive Compensation Conference to receive reduced rates.]

Special Rates: To accommodate the different needs of our community, we offer the following attendance alternatives:

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