

**The SEC's 2006 Executive
Compensation
Disclosure Rules:
An Overview and an
Assessment of First-Year
Compliance**



Prepared by
Council of Institutional Investors

This white paper is designed to provide an overview of the Securities and Exchange Commission's disclosure rules for executive compensation and is not a comprehensive discussion of all aspects of the regulations. While the Council exercised due care in preparing this report, it does not guarantee the accuracy of the information.

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The SEC's 2006 Executive Compensation Disclosure Rules: An Overview and an Assessment of First-Year Compliance

For years, investors have urged the Securities and Exchange Commission (SEC) to require companies to disclose detailed, clear, plain English information about their executive compensation packages and the philosophies and decision-making processes that underpin them. Revelations about rampant stock options backdating and exorbitant severance packages only heightened shareowners' desire for more information and clarity about pay practices. In July 2006, the commission responded by adopting a sweeping overhaul of the rules that determine what companies must disclose about executive pay packages in their annual proxy statements. This paper provides an overview of key components of the new disclosure regime and assessments by SEC staff, institutional investors, proxy advisory services and compensation experts of the first-year implementation of the rules.

I. Overview of the new disclosure regime

The SEC's goals in overhauling compensation disclosure rules

The commission's effort to retool pay disclosure came 14 years after its last changes in this area. "Executive compensation has changed substantially since 1992 but disclosure rules have not, so chasms in disclosure have resulted, and at the same time what the SEC did require has drifted toward boilerplate and legalese," said John White, director of the SEC's Division of Corporation Finance, upon releasing the final rules in July 2006.

Anne Krauskopf, senior special counsel for the SEC's Division of Corporation Finance, said that executive compensation had evolved to a point that the required pay disclosure tables no longer captured it adequately. "We wanted to plug those holes while retaining the strengths of that former form," she explained. Krauskopf said the commission's overhaul focused on three main goals: 1) more comprehensive tables; 2) broader, principles-based narrative to flesh out the tabular disclosure; and 3) more accessible, plain English explanation.

The objective was “to improve disclosure by including the total mix that is available so that shareowners have more complete information to reach their own conclusions and make their investment and voting decisions,” she said. “The new rules are not about providing any guidance or judgment as to appropriate amounts or forms of compensation.”

The SEC aimed to strike a balance between investors’ desire to see all the details of executive compensation and the cost to companies of presenting this information, said Mark Borges, a principal with consulting firm Compensia.

Compensation Discussion & Analysis

One of the major new additions to proxy disclosure is the Compensation Discussion & Analysis (CD&A). The goal of the CD&A is to provide an overview that discusses why certain levels of compensation were selected and how the compensation figures detailed in tables in the proxy statement reflect those policies. The analysis is supposed to clarify why the overall compensation program was set up the way it was, what the company seeks to achieve from the program and whether the plan is achieving the desired results. It should be a clear, informative discussion of the hows and whys of executive compensation, rather than simply an inventory of the elements of pay. Specifically, the CD&A explains and provides analysis of key elements of a company’s compensation goals, practices and decisions for the principal executive officer (CEO), principal financial officer (CFO), the three other highest-paid executive officers and the directors. Disclosures should be sufficiently precise to identify material differences in compensation policies and decisions for the five named individuals. Where policies and decisions are similar, executives may be discussed together.

The new CD&A represents a balance between disclosures that the SEC requires and disclosures that it suggests be included if they are material to an understanding of its executive compensation package. “The principles-based disclosure concept allows each company to assess its own facts and circumstances and determine what elements of the company’s compensation policies and decisions are material and warrant disclosure,” the

SEC explained in an October 2007 paper entitled “Staff Observations in the Review of Executive Compensation Disclosure.”

The CD&A must be filed with the SEC, which means that the CEO and CFO must certify it and that they are subject to the liability provisions of the Securities Act of 1933 and the Securities and Exchange Act of 1934. In addition, the compensation committee must review and discuss the CD&A with management and furnish the SEC with a brief compensation committee report confirming that it has done this.

Although the CD&A focuses on compensation in the last fiscal year, depending on the circumstances, a company also may need to talk about prior-years pay, post-termination arrangements, ongoing programs, policies that it will apply going forward and actions taken after the end of the fiscal year.

Required Disclosures

In the final rules issued in July 2006, the SEC said that a company must address six questions in its CD&A:

- What are the objectives of the company’s compensation programs?
- What is the compensation program designed to reward?
- What is each element of compensation?
- Why does the company choose to pay each element?
- How does the company determine the amount (and, where applicable, the formula) for each element?
- How do each element and the company’s decisions regarding that element fit into the company’s overall compensation objectives and affect decisions regarding other elements?

Optional Disclosures

The SEC also suggested that a company could disclose the following 14 items *only if* it believes they are material to the compensation package:

- policies for allocating between long-term and currently paid-out compensation
- policies for allocating between cash and non-cash compensation, and among different forms of non-cash compensation
- the basis for allocating long-term compensation to each different form of award
- how the company determines when awards are granted, including awards of equity-based compensation such as options
- what specific items of corporate performance are taken into account in setting compensation policies and making compensation decisions
- how specific elements of compensation are structured and implemented to reflect these items of the company's performance and the executive's individual performance
- the company's policies and decisions regarding recoupment of executive bonuses in cases of financial restatements
- the factors considered in decisions to increase or decrease compensation materially
- how compensation or amounts realizable from prior compensation are considered in setting other elements of compensation (e.g., how gains from prior option or stock awards are considered in setting retirement benefits)
- the impact of accounting and tax treatments of a particular form of compensation
- the basis for selecting particular events as triggering payments for change-in-control and termination plans
- the company's equity or other security ownership requirements or guidelines and any company policies regarding hedging the economic risk of such ownership
- whether the company engaged in any benchmarking of total compensation or any material element of compensation, identifying the benchmark and, if applicable, its components (including component companies)
- the role of executive officers in the compensation process

The SEC emphasized that each company should tailor its CD&A to its particular circumstances. “These examples are just that,” explained the SEC’s White, in an Oct. 9, 2007 speech. “Companies need not discuss each example, as disclosure is required only where material.”

Performance Targets

The rules require companies to disclose specific performance targets that executives must meet to receive bonus payouts. But a company may decline to reveal such goals if doing so would undermine the confidentiality of trade secrets or confidential commercial or financial information and disclosure would cause competitive harm. If a company withholds performance targets, however, it must discuss how difficult it would be for the executive—or how likely it would be for the company—to achieve the undisclosed target levels. The rules also warn that the SEC may require a company that uses this safe harbor to demonstrate that the particular factors or criteria involve trade secrets or confidential commercial or financial information and why disclosure would result in competitive harm. If the SEC ultimately determines that a company has not met these standards, it will require the company to disclose the performance targets.

Summary Compensation Table: Whither total pay?

Among the most-heralded changes in the new rule regime was the inclusion of a new column in a more detailed summary compensation table showing total compensation. “There will now be one bottom line number, including all options, for an executive’s total compensation, and that number will be comparable from company to company,” SEC Chair Chris Cox said in July 2006. And investors would finally be able to do cross-company and year-to-year comparisons of the full panoply of CEO pay, including salary, bonuses, option grants, pensions and perks.

But last-minute tweaks the SEC made in the rules compromised the way total CEO pay is reported, muddying investors’ ability to make comparisons. The disclosure plan the SEC adopted in July 2006 required companies to report the full grant date fair value of stock awards and stock option awards granted to executives in the last fiscal year as the basis for the stock compensation figure in the summary compensation table. But in late

December, the SEC decided instead to require companies to report the accounting cost of options and awards that vested in the fiscal year.

The commission said that the new formula more accurately reflected stock options actually earned in a given year. Using the fair value of options granted under the previous rules meant that if an executive left the company before her options vested, the full amount of the options was reported in the table, even if the executive pocketed no options, the SEC said. The commission also argued that the amended rule would eliminate the chance that a single large grant to one executive, earned over several years, could rope her in as one of the five named executive officers in the summary compensation table even if the grant was just a one-time event.

Many institutional investors countered that the SEC's formula could yield a distorted picture of equity and total pay and makes analyzing pay over time and against peers extremely difficult. It also obscures the compensation committee's decisions about options for top executives in a given year.

The new rule also treats option grants issued to those eligible to retire differently from those issued to other executives, which many investors say further clouds the summary compensation table. For example, if an executive is eligible for retirement when the option was granted, and could keep the option if he retired, the entire option grant would be expensed and listed in the table the year it was granted. If however, the executive is not eligible for retirement, the option expense would be spread out over the vesting period, generally three to five years, and reported piecemeal in the summary compensation table.

New Disclosure about the Timing of Stock Option Awards

Revelations of abusive timing of employee stock options by scores of companies prompted the SEC to require specific disclosures relating to options. In a separate table, companies must reveal the date the compensation committee or full board granted an award if that date is different from the grant date, a description of the methodology for determining the exercise price of options if the exercise price is not determined based on

the closing market price on the date of grant, and the amount of securities underlying unexercised options, the exercise prices and the option expiration dates for each outstanding option. In the CD&A, companies are required to discuss the following:

- whether the company coordinates option grants with the release of non-public information
- how the timing of the options grants to executives fits in the context of grants to employees in general
- the role of the compensation committee in the timing of option grants and how it factors non-public information into making option grants
- any delegation by the compensation committee of the administration of options grants
- the role of executives in the timing of option grants

Retirement and other Post-Employment Pay

The new rules lifted the veil on retirement benefits, change-in-control and other termination compensation arrangements. Previously, most companies revealed little about post-employment pay. The SEC replaced the former pension plan table, alternative plan disclosure and some of the other narrative descriptions with a table and explanation of the details of defined benefit pension plans. The commission also added a table and narrative disclosure about nonqualified defined contribution plans and other deferred compensation. Previously, investors often could not find specific potential pension benefits relating to particular named executive officers. The new table requires disclosure of the present value of each named executive officer's accumulated benefit under the plan and her credited years of service. A separate row is provided for each plan in which a named executive officer participates. The SEC says this approach achieves comparability and transparency by disclosing a benefit that already has accrued, and it ties this table to the summary compensation table's disclosure of increases in pension value.

Whether or not the plan allows for a lump-sum payment, disclosure of the present value of the accrued plan benefit provides information about the cost of promised future

benefits in present value terms. The rules require a company to use the same assumptions, such as those about interest rates used under the generally accepted accounting principles. But it also must assume a normal retirement age as defined in the plan, or if an age is not defined, the earliest time at which a participant may retire under the plan without any benefit reduction. The estimates are based on current compensation. The valuation method and all material assumptions must be described in the narrative section accompanying the table.

Perquisites

The new rules require disclosure of perquisites and other personal benefits for named executive officers and directors that exceed \$10,000. A company must also identify in footnotes what the perks and other personal benefits actually were. Previously, a company did not have to disclose perks if the aggregate amount was less than \$50,000 or 10 percent of the total of annual salary and bonus. And only perks that were at least 25 percent of the total amount for each named executive officer had to be identified. Now, unless the aggregate value of perks is less than \$10,000, any personal benefit must be revealed. If the value of a perk exceeds the greater of \$25,000 or 10 percent of total perquisites for a named executive officer, its dollar value must be quantified and disclosed in a footnote. And a company must now also reveal in a footnote the methodology it used to determine the aggregate incremental cost of perquisites.

What counts? Any personal benefit that is not directly related to the performance of the executive's duties unless it is generally available on a non-discriminatory basis to all employees. Specifically, the SEC lists the following as perks or personal benefits that must be disclosed: club memberships not used exclusively for business entertainment purposes, personal financial or tax advice, personal travel using vehicles owned or leased by the company, personal travel otherwise financed by the company, personal use of other property owned or leased by the company, housing and other living expenses (including but not limited to relocation assistance and payments for the executive or director to stay at his or her personal residence), security provided at a personal residence or during personal travel, commuting expenses (whether or not for the company's convenience or benefit) and discounts on the company's products or services not

generally available to employees on a non-discriminatory basis.

Compensation Consultants

A company must disclose the role of its compensation consultants in determining or recommending the amount or form of executive and director compensation. A company must also identify its consultants and state whether consultants were engaged directly by the compensation committee (or persons performing the equivalent functions) or any other person. The nature and scope of the consultant's assignment and the material elements of the instructions or directions given to the consultants about their duties also must be explained. The rules do not, however, impose an independence standard; the compensation committee may engage a consulting firm that also provides services to the company's management.

II. Assessing the First Year of Implementation

The View from the SEC

In October 2007, the SEC published observations based on a review of executive compensation disclosure in 2007 proxy statements of 350 public companies. The staff assessed how well the companies had complied with the rules and sent comment letters to those with disclosures it deemed insufficient. In selecting the 350 companies, the SEC said it sought a cross-section of industries and did not choose any based on the quality of their specific disclosures.

Overall, the commission criticized the language, format and clarity of proxy statements. "Far too often, meaningful analysis is missing—this is the biggest shortcoming of the first-year disclosures," the SEC's White said in an Oct. 9, 2007 speech. Specifically, he said the following points were either lacking or missing entirely:

- how and why compensation philosophies and decision-making processes resulted in the numbers presented in compensation tables
- how the amounts paid or awarded under each compensation element, and how the total compensation delivered from all these elements, affected the

decisions made regarding amounts paid or awarded under other compensation elements

- how benchmarks were used and how they affected compensation decisions
- differences in compensation policies and decisions among executive officers
- the rationale for the way change-in-control and termination arrangements were structured
- how potential payments and benefits under change-in-control and termination arrangements may have influenced decisions regarding other compensation elements
- how performance targets were used in setting compensation

While there was extensive detail on individual compensation components, White said, there was scant discussion about how the amounts paid or awarded under each element affected decisions regarding amounts paid or awarded under other elements. He also faulted companies for failing to discuss how wealth accumulation from total compensation delivered affected pay decisions.

**What the Division of Corporation Finance
looks for as it reviews CD&As:**

- Is there clarity in the compensation analysis and description?
- Is the compensation analysis in plain English?
- Did the company withhold performance targets because it wants confidential treatment?
- If the company withheld performance targets did it provide an explanation of how difficult they were to achieve or how likely it was that the company would achieve them?
- How much influence did the CEO appear to have in the compensation-setting process?

Source: John White's speech to Compliance Week's annual conference Jun 6, 2007.

White warned that the SEC would press companies that appeared to be on shaky ground in withholding performance targets to justify their use of confidential treatment.

“Companies that are using the exclusion and therefore not disclosing their specific performance targets should be prepared to provide the staff with an open and full explanation of those decisions and those targets,” he said in a June 6, 2007, speech. Even when performance targets are validly protected by the exclusion, companies still must provide investors with a sense of how difficult the goals are to achieve or how likely they will be met. “I am not impressed by disclosure that targets ‘are difficult but possible to achieve’ without more,” White warned.

The SEC’s Krauskopf told those gathered at a June 22 conference sponsored by the American Law Institute-American Bar Association that SEC staff asked the following questions when it reviewed pay disclosures of 350 companies:

- What can be fixed by better compliance?
- What can be fixed by better interpretation?
- What can be fixed by changes to the rules?

In letters to the 350 companies, the SEC called for more plain English, better organization of tables and graphs and the use of executive summaries and charts and tables tailored to a company’s particular compensation program. The SEC also admonished companies not to make alternative summary compensation tables more prominent than the required table. In some instances, the SEC asked companies to explain the differences between compensation amounts shown in alternative tables and those in required tables.

Consultants, Proxy Advisers and Investors Take Aim

Outside the SEC, the verdict on the first year of CD&A disclosure was the same: too long, too turgid, too much “what” and not enough “why.”

A study by human resources consultant Mercer found that the length of proxy statements increased overall. The study also found that, applying various “readability metrics” to proxy statements, “disclosures were more difficult to read than the Bible, the U.S. Constitution and *The New York Times*.”

The narrative part of the CD&A “has thrown companies for a loop,” executive compensation expert James Reda said. “The people involved in writing the CD&A generally are results-oriented, so a principles-based document is difficult for them.” David Engvall, a partner at the law firm of Covington & Burling, warned that the CD&A was prone to the same weaknesses of previous compensation committee reports: “In the ‘management discussion and analysis’ section of that report many companies just erased the numbers, put in new ones and left the text from year to year. The CD&A could fall prey to the same thing.”

Consultant Watson Wyatt Worldwide recommends that its clients include a table in the CD&A that breaks down all compensation into either total compensation opportunity or total compensation realized. Said Steve Seelig, the firm’s executive compensation counsel: “The current rules blur the line between the concepts of pay opportunity versus realizable pay. We think of pay opportunity as the compensation granted during the year: salary, bonus opportunity at target and equity grants. Pay opportunities typically don't vary much by performance, in our experience, although they are often the focus of press accounts regarding how much a CEO earned last year.” Realizable pay, Seelig explained, is what an executive earns each year including salary, cash bonus and LTI paid, increase in restricted stock values, and the change of in-the-money value of options. “We think this is an accurate measure of what the [CEO] actually earned during the year and believe, for companies that truly have a pay-for-performance program, will have their realizable pay vary by the stock value created,” he said. Until companies are required to disclose their performance targets this is the best way to determine if companies truly are linking pay to performance, Seelig emphasized.

Institutional investors complained most about the length of CD&As and their lack of substantial analysis. Said Tracy Stewart, senior governance analyst at the Florida State Board of Administration: “It’s as if [companies] were trying to say as much as possible without saying much at all.”

John Wilcox, senior vice president of corporate governance at TIAA-CREF, bemoaned the similarity of many CD&As. “We are not seeing company-specific, customized, genuinely informative disclosure that is closely linked to the management discussion and analysis and the business plan,” Wilcox said. Still, he thought that CD&As will improve over time. “My impression is that this year companies were scrambling and were just concerned with getting the numbers in the correct columns,” he said. “In the process, many discovered that they didn’t have a compensation philosophy.” Wilcox wished more companies would begin their disclosure with an executive summary. “This way investors can look at the overview and then drill down to get the specific information they need,” he said.

Bill McGrew, portfolio manager for California Public Employees’ Retirement System (CalPERS), said companies too often substituted verbosity for clarity. “The amount of information disclosed should not be interpreted to be indicative of the quality of the information disclosed,” he said. “We have to be able to distinguish between a data dump and a substantive disclosure.”

Concerns about length and a lack of substance were echoed by proxy advisers RiskMetrics (which acquired Institutional Shareholder Services in January 2007), ProxyGovernance and The Corporate Library. “Compensation committees could have done a better job of telling the story to shareholders,” said Martha Carter, head of the ISS Global Policy Board at RiskMetrics, “We thought they would get into the philosophy behind pay and how pay is tied to performance, but we heard from lawyers and not compensation committees, and a large part of what we saw was vague boilerplate.” Most of the CD&As that RiskMetrics reviewed were not unique and many provided too much detail about how incentive plans work without explaining motivation or intent, Carter added.

Allie Monaco, vice president of research for Proxy Governance, warned that “a lack of information may result in our recommending ‘withhold’ votes from compensation committee members.” Proxy Governance, she explained, uses a proprietary model to

evaluate a company's executive pay relative to peers and performance, rather than a bright-line test to determine when compensation is excessive. "We examine the proxy disclosures to get behind the numbers, and for this type of company-specific evaluation, the CD&A becomes very important," she said.

Alex Higgins, an analyst at The Corporate Library, thought the amount of information disclosed often was so excessive that it left many investors confused as to what was "material" and what was not.

III. Key Concerns about Implementation

Total Confusion about Total Pay

The SEC's late-December (2006) change in the rules to let companies report the accounting cost of options and awards that vested in the fiscal year, rather than the grant date fair value, undermined the goal of providing a clear picture of total CEO compensation. Said TIAA-CREF's Wilcox: "The December change leaves us with multiple answers to the question of how much the CEO made last year." McGrew of CalPERS agreed: "How the information is disclosed under the new rule makes it difficult to compare compensation trends over the past few years. Investors, proxy advisors and other interested parties must create new measurement tools to trace levels going forward."

Some companies actually reported *negative* numbers in their summary compensation tables, because a drop in the stock price lowers the value of options, resulting in reduced compensation for accounting purposes. In one widely cited example, the summary compensation table in Brookfield Homes' 2007 proxy statement reported that CEO Ian Cockwell made a negative \$2.3 million in 2006, even though he actually pocketed nearly \$8 million in total compensation. Equilar reported that 2 percent of the 900 proxy statements it reviewed had negative numbers.

The reduction in reported pay under the revised rules was greatest for those companies that accelerated the vesting of their options in 2005 to avoid reporting them as an expense when a new accounting rule went into effect. Most of the options for these executives already had vested and thus do not have to be reported in the new table.

Compensation firms such as Equilar and Mercer and media organizations like the Associated Press (AP) rejected the SEC’s methodology for toting up option awards. Many also disagreed with other aspects of the SEC’s total pay formula and devised their own definitions. As a result, consensus on what constitutes “total compensation” remains elusive. The table below shows varying methods used to calculate total compensation by the SEC, AP, proxy voting advisers and other consultants and credit rating agencies:

	SEC	Associated Press	Corporate Library	Equilar	Mercer	Moody's
<i>Salary</i>	Yes	Yes	Yes	Yes	Yes	Yes
<i>Bonus</i>	Yes	Yes	Yes	Yes	Yes	Yes
<i>Non-equity Incentive</i>	Yes	Yes	Yes	Yes	Yes	Yes
<i>Pension Value Change</i>	Yes	No	Yes	Yes	Yes	No
<i>Nonqualified Deferred Compensation Earnings</i>	Yes	Yes	Yes	Yes	Yes	No
<i>Other</i>	Yes	Yes	Yes	Yes	Yes	Yes
<i>Options</i>	Financial Accounting Compensation Expense of Options	Company-furnished Grant Date Fair Value of Options	Value Realized on Exercise of Options	Black-Scholes Value of Option Awards	Black-Scholes Value of Option Awards	Company-furnished Grant Date Fair Value of Options
<i>Non-option Equity Incentives</i>	Financial Accounting Compensation Expense of Stock Awards	Company-furnished Grant Date Fair Value of Stock Awards	Value Realized on Vesting of Non-option Equity Incentives	Grant Date Value of Non-option Equity Incentives*	Grant Date Value of Non-option Equity Incentives**	Company-furnished Grant Date Fair Value of Stock Awards
<i>Payments from a Vested Retirement Benefit Plan</i>	No	No	Yes	No	No	No

**Equilar values all non-option equity using the closing stock price on the date of grant*

***Mercer’s definition of non-option long-term incentives includes restricted stock grants, performance-based equity grants and performance-based cash grants.*

Disclosure about the CEO’s Role in Setting Pay

While the rules encourage companies to discuss the CEO’s role in setting pay, the SEC review found that many skirted the subject. In a May 3, 2007, speech White said investors needed to know more: “Did the CEO have the ability to call or attend even portions of compensation committee meetings? Did she meet with any consultants used by the compensation committee? Did the CEO retain or have access to any other

compensation consultants who influenced the company's executive compensation? What input did the CEO have as compensation packages were being crafted? These are just some examples of the types of principles-based questions that companies should be asking and then considering disclosure of the answers." Many of the letters that the SEC sent out in October requested more information about the role the CEO plays in setting director and executive pay.

Carter of RiskMetrics agreed that discussions of the CEO's role were skimpy. "Recently, we saw a proxy that disclosed that although the CEO was not on the compensation committee, he attended all of the committee's meetings," she said. "There's a lot more involvement than we realize of the CEO with compensation committees." Carter also emphasized that the CEO's role in setting non-executives' pay, as well as how the company values its employees and any internal pay disparities, should be disclosed in the CD&A. McCauley of Florida State Board of Administration, said the SEC will have to push on this issue because "there won't be a natural inclination for companies to disclose their CEO's involvement in setting executive compensation."

Keeping Performance Targets Under Wraps

In its examination of 350 corporate proxy filings, the SEC issued more comments regarding performance targets than any other disclosure topic. "We often found it difficult to understand how companies used these performance targets or considered qualitative individual performance to set compensation policies and make compensation decisions," said the commission. "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." The SEC's comment letter stated that a company should supply this information when:

- it has a multiple-year compensation plan
- target levels vary materially between years

- its disclosure implied that its current or prior-year targets were material to an understanding of a named executive officer's compensation for the last fiscal year

A study by Watson Wyatt Worldwide found that many companies had sought shelter in the SEC safe harbor that permits a company to withhold performance targets to protect confidential or trade secrets. Its analysis of 2007 company proxy statements found that 46 percent of the 100 largest U.S. companies studied did not disclose the actual goals on which they based rewards under their 2006 annual incentive plans. And 45 percent did not include the goals for long-term incentive plans. Many of the companies that failed to disclose performance targets did reveal the underlying financial metrics used to set executive compensation, (i.e. earnings per share, operating income or other metric) but not the actual goals. Eighty-five percent of companies disclosed the metrics on which the annual awards were based; 73 percent disclosed metrics for long-term incentives.

Across the board, public and union pension funds and proxy advisory services questioned whether many of the companies that did not disclose performance targets would really suffer competitive harm if they did. The goals are critical indicators of whether pay is adequately linked to performance and their absence leaves crucial questions unanswered, they said. Not knowing the targets, said Stewart of the Florida SBA, "puts shareowners in the position of signing a check to executives for a certain amount without knowing what [they are] paying for."

Daniel Pedrotty, director of the AFL-CIO's Office of Investment, worried that the absence of performance goals in proxy statements may mean companies are "moving the goalposts or setting the bar too low." He suggested retrospective disclosure of targets after the performance period as a way to address the problem. That option found favor also with Carter, McGrew and McCauley. "I don't understand how companies can say something is historically confidential," McCauley said. (But several companies argued in comment letters prior to the SEC's adoption of the final rules that they select measures for their relevance to the company's business strategy over several years, so that even

disclosure on an after-the-fact basis could reveal proprietary, competitively sensitive business information).

Carter, Monaco, Higgins and Wilcox all argued that few companies qualify for the competitive harm exemption. “Since earnings per share and total shareholder returns are the most common measures, we wonder how confidential this information really is,” said Carter. Monaco called the companies’ arguments “tiresome” and pointed out that those companies that have disclosed this key information have not suffered negative consequences. Higgins noted that companies are required to disclose material information related to their strategic objectives in quarterly and annual reports, and, therefore, should not find it necessary to omit that information from their proxy statements. She also said big, well-known companies seem to be more willing to disclose their targets than smaller companies.

Wilcox argued that companies in the same industries already know a great deal about each other and employees within an industry move from company to company “so it’s not as if these are deep, dark secrets.” McCauley was optimistic that the SEC would take action: “Ideally I would like to see the SEC mandate disclosure of all of this information, but I think the SEC will require through additional clear guidance, that companies should disclose anything that is not confidential or proprietary.”

Most also agreed that companies choosing not to disclose their performance targets have not done an adequate job of describing how difficult it would be for the executive, or how likely it would be for the company, to achieve the undisclosed target levels. “How do you do a good job of disclosing something that you don’t disclose?” asked Carter.

Stealth Compensation No More

Investors were pleased with their sudden access to formerly hidden information about retirement pay, change-in-control and severance benefits. “Potential change-in-control payout values, executive compensation recoupment policies and option grant procedures are improvements of the new disclosure as it paints a more complete picture of expected

compensation windfalls and shareowner protections,” said McGrew.

McCauley called the inclusion for the first time of “stealth’ elements of compensation—such as SERPs (supplemental executive retirement plans), deferred compensation arrangements under which deferred amounts earn high levels of interest, perquisites, consultant fees received post-retirement and generous loans to executives—the “most significant achievement within the new disclosure regime.”

But some investors urged more uniform disclosure and tables that tote up these various forms of pay. A study by Mercer found that Google’s proxy statement included a half-page to describe termination and change-in-control arrangements, while J.C. Penney used 28 pages, or one-third of its proxy statement, to explain its payments under those circumstances. Although all companies must disclose the same information, they have considerable leeway in how they present the data. Investors also expressed a strong desire for companies to include multiple years of comparable data.

Sunlight Chases Some Perks Away

Reports suggest that the anticipated disclosure of perquisites under the new rules prompted many companies to preemptively eliminate or reduce perks. A survey of 350 major U.S. companies by Mercer Human Resource Consulting for *The Wall Street Journal* found that 28 companies had cut or curbed at least one CEO perk in 2006. A Jan. 29, 2007, article in *Investment News* noted that free financial planning for executives appeared to be one of the first perks to go. The story cited Lockheed Martin and Ryder System as two of the firms that were jettisoning these extras.

Instead, some companies gave their executives a one-time lump sum to use toward financial planning, while others were rolling the value of the perk into the executives’ base salary by creating a “perk allowance” that could be used at the executive’s discretion. An April 9, 2007, *Wall Street Journal* article noted that personal use of the corporate aircraft, club membership dues, ‘gross up’ payments to cover executives’ taxes on certain benefits and company cars were also on the chopping block.

Using the additional disclosure provided under the new rules, Equilar studied aircraft-related perks for CEOs of companies in the Fortune 100 and found that companies were not as stingy as media reports suggested. Among Equilar's findings:

- In 2006, the median value of aircraft-related perks for Fortune 100 chief executives was \$121,676. This amount represents a 12.1 percent increase over the median of \$108,579 reported in 2005.
- The median value of CEO aircraft perks grew faster between 2004 and 2005, when the median value increased by 21.7 percent from \$89,246 in 2004.
- The values cited above for all years exclude the value of "gross-ups" or tax reimbursements associated with the personal use of corporate aircraft. In 2006, CEOs at 27.4 percent of Fortune 100 firms received a median gross up of \$10,771 for taxes incurred as a result of personal use of corporate aircraft.
- In 2006, 78.5 percent of companies indicated that their CEO used corporate-owned, leased, or chartered aircraft for personal use. In 2005, 68.4 of companies made such a disclosure, and in 2004, only 59.4 percent of companies reported that their CEO received aircraft-related perks.

Some governance experts viewed the use of perk allowances as a mixed blessing. "At least the cash payments allow for comparison with other companies, but one would hope that the compensation committee would oversee how the cash is spent," said Carter of RiskMetrics. She added that companies continue to grant tax gross ups on perks, a practice that she viewed as "the antithesis of pay for performance."

Pressure to Minimize Compensation Consultants' Conflicts of Interest

Many investors were disappointed that the SEC did not impose independence standards on compensation consultants similar to those placed on outside auditors. In October 2006, a group of institutional investors, including Connecticut Retirement Plans and Trust Funds and the California State Teachers' Retirement System, wrote to the compensation committee chairs of the 25 largest U.S. companies (by market

capitalization) in the S&P 500. The letters asked the companies to state whether the consultant employed by the compensation committee provided any other consulting services to the company's management, the nature of that work and whether it was disclosed in the CD&A portion of the proxy statement. The letters also asked whether the company's board had a policy barring the compensation committee's consultant from providing other services to the company's management, and if not, would it adopt one and disclose it in the CD&A portion of the proxy statement?

The letters also asked the chairs to express a willingness to adopt formal policies to prevent compensation consultants from working for both management and the board. Eighteen of the 25 companies responded indicating that they had adopted formal policies to ensure independence or established guidelines at the compensation committee.

Other activist shareowners decided to target unresponsive companies with proposals asking them to provide a report on the company's relationships with its executive compensation consultants or firms. Specifically, the proposals requested that the company disclose:

- the identity of the entity
- whether any member of senior management participated in the process of selecting or retaining the consultant
- whether the consultant has provided at any time in the last five years non-compensation-related services to the company or any of its affiliates including services provided by the consultant through an affiliate
- the company's policies and procedures regarding non-compensation-related services provided by its consultant

The three proposals on this topic that came to a vote in 2007 received average support of 40 percent of the votes cast. Some activist funds plan to submit similar proposals for the 2008 proxy season.

Compensation consultants' potential conflicts of interest also have captured the attention of lawmakers on Capitol Hill. In May, Rep. Henry Waxman (D-Calif.), chair of the House Committee on Oversight and Government Reform, asked the largest compensation consulting firms for details on their client relationships and the revenues these ties have generated. Specifically, he asked them to identify which companies among the nation's 250 largest they had provided both executive pay consulting and other services for and to disclose total revenues received for each type of service. "Almost everyone agrees the extravagant increases in executive compensation make no sense," Waxman said in a statement. "The question I'm looking at is whether potential conflicts of interest among compensation consultants and their corporate clients might play a role in some of the irrational compensation decisions."

McCauley said the new rules "have opened up the dialogue about the services that compensation consultants provide to companies. It seems as if the major comp consultants are willing to disclose how and what they do for companies, it's just the companies that are hesitant." The AFL-CIO's Pedrotty said the disclosure required under the new rules is inadequate and should include information about whether the CEO played a role in selecting the consultant and whether the company has a policy to address conflicts of interest.

IV. Going Forward

Investors already are using the new disclosures to push back at companies where they believe pay is excessive or not sufficiently tied to performance. The United Brotherhood of Carpenters and Joiners of America is using the peer groups and CD&As to better target its pay-for-superior-performance proposals in 2008. The Connecticut Retirement Plans and Trust Funds aims to use the new disclosure about the compensation levels for each of the named executive officers to submit proposals to companies where there appears to be egregious internal pay inequities among them.

The quality of corporate pay disclosures likely will improve over time. In a speech entitled, "Tackling Your 2008 Compensation Disclosures," the SEC's White offered companies a great deal of practical advice about how to draft the executive compensation

disclosure for their 2008 proxy statements. He emphasized that companies should not use last year's disclosures as a mark up, but instead should start with a clean slate and consider the following questions:

- What is material to my shareowners, to my investors, as they examine the compensation of our executives and make their voting decisions for our board of directors and investment decisions with respect to our company?
- What are the material elements of individual executive and corporate performance that are considered in setting executive compensation?
- What is the relationship between the objectives of our compensation program and the different elements of compensation?
- What are the material factors that relate to our compensation decision-making process?

He then suggested focusing on a discussion and analysis of the hows and whys in the decision-making process while at the same paying attention to being clear, concise and understandable.

He concluded his remarks by recommending that companies give each person who participates in setting pay, from the compensation committee chair on down, a piece of paper with the caption "analysis" and ask them to list bullets reflecting what they see as hows and whys related to the following factors:

- key analytic tools used by the compensation committee
- findings that emerged from the analysis
- resulting actions taken impacting executive compensation in the last year

Regardless of the shortfalls of the new disclosure regime, or of companies' compliance with the rules, the process that compensation committees now must engage in is extremely valuable. Many committees are tallying up—many for the first time—how much has been awarded to executives over the course of their careers. The new requirements are also prompting compensation committees to trim perks, consider

instituting clawback provisions to recoup executives' bonuses after financial restatements and to evaluate internal pay inequities among the CEO and other top officers. A January 2007 survey by Mercer of 110 companies found that one-third of respondents made, or planned in the next year to make, changes to their stock-option programs. Half of those that indicated that they would make changes planned to alter their grant practices so that all stock-option grants would be made on a yearly fixed date. More dramatic changes could be in store if the rules prod compensation committees to strive to ensure that executives truly are paid for their performance. As SEC Chair Cox has said: "A company that is required to undress in public will pay more attention to its figures."

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