



Testimony of
Jeffrey P. Mahoney
General Counsel
Council of Institutional Investors
before the
Permanent Subcommittee on Investigations
of the
Committee on Homeland Security and Governmental Affairs
June 5, 2007



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Table of Contents

TABLE OF CONTENTS

Prepared Statement

Full Text of Statement

Attachments

1. Council of Institutional Investors (“Council”) General Members
2. Council Corporate Governance Policies
3. Council Board of Directors
4. Council Correspondence Referenced in Full Text of Statement



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Prepared Statement

Chairman Levin, Ranking Member Coleman, and Members of the Subcommittee:

Good morning. I am Jeff Mahoney, general counsel, of the Council of Institutional Investors (“Council”). I am pleased to appear before you today on behalf of the Council. I have brief prepared remarks and would respectfully request that the full text of my statement and all supporting materials be entered into the public record.

The Council is a not-for-profit association of more than 135 public, labor and corporate pension funds with assets exceeding \$3 trillion. Council members are generally long term shareowners responsible for safeguarding assets used to fund the pension benefits of millions of participants and beneficiaries throughout the United States (“US”). Since the average Council member invests approximately 75 percent of its entire pension portfolio in US stocks and bonds, issues relating to US corporate governance are of great interest to our members.

The Council has long believed that executive compensation is one of the most critical and visible aspects of a company’s governance. Analyzing and evaluating pay decisions, including decisions involving the granting of executive stock options, is one of the most direct ways for shareowners to assess the performance of boards of directors.

Moreover, executive compensation decisions have a bottom line effect, not just in terms of dollar amounts, but also by formalizing performance goals for executives. As a result, approximately one-half of the Council’s corporate governance “best practices” policies focus on executive compensation issues.

In recent months, the Council has been active on three important corporate governance fronts involving executive stock options. First, in March of this year, the Council's general membership unanimously approved a revision to the Council's corporate governance policies. That revision recommends that companies provide annually for advisory shareowner votes on compensation of senior executives. In approving this policy, Council members generally agreed that an annual advisory vote on executive compensation would benefit investors and company governance because it would provide a mechanism for shareowners to provide ongoing input to company boards on how a company's general compensation policies for executives, including policies relating to stock options, are applied to individual pay packages.

Second, the Council has publicly raised concerns with the Securities and Exchange Commission's ("SEC" or "Commission") December 2006 amendments to the Commission's new proxy statement disclosure rules on executive compensation and related party disclosure. Those amendments lessened the usefulness of the information contained in company proxies by changing the requirements for the reporting of the amount of executive stock option and equity-based awards that appear in the new summary compensation table.

As a result of the change, the summary compensation table, as revised, no longer informs investors of the compensation committee's current actions regarding executive stock options and similar equity-based awards. Moreover, the change sometimes results in the reporting of a negative compensation amount which I believe most parties, including the SEC, would agree is not particularly useful information when assessing the performance of compensation committees.

We are pleased that the SEC staff has publicly acknowledged our concerns and other investor concerns that have been raised about other disclosure issues relating to the initial implementation of the new rules. The SEC staff has indicated that they are initiating a “review project” that will result in a report this fall that analyzes the first year compliance with the new rules. We look forward to reviewing and commenting on the report.

Finally, we have been monitoring the implementation of the Financial Accounting Standards Board’s (“FASB”) new standard on the accounting for stock options. That standard, which became effective last year for most companies, is important to investors because it closes a “loophole” in financial reporting.

The loophole had the effect of (1) encouraging companies to issue an excessive amount of so-called “fixed-price” stock options to the exclusion of other forms of stock options and other forms of compensation that are more closely linked to long-term performance, and (2) permitting companies to understate their compensation costs distorting financial reports and as a result diverting investment and capital resources away from their most efficient employment.

The ongoing stock option backdating scandal provides a reminder that the financial accounting and reporting for executive stock options is an area in which there is a high risk of misapplication of reporting requirements. The Council, therefore, has been advocating that audit committees, external auditors, the Public Company Accounting Oversight Board, and the Commission, should all actively support the high quality implementation of the new FASB standard on accounting for stock options.

In that regard, representatives of the Council staff and the CFA Institute Centre for Financial Market Integrity recently met with staff of the SEC's Office of the Chief Accountant to discuss our concerns about the potential use in financial reports of prices Zions Bancorporation ("Zions") has received in its recent offerings of a financial instrument they developed called "Employee Stock Option Appreciation Rights" or "ESOARS." Zions has proposed that the price for its ESOARS qualify as a market-based approach for valuing stock option awards for financial reporting purposes both for itself and for other public companies.

After consulting with leading valuation and accounting experts, the Council staff has concluded that, as presently constructed, Zions ESOARS results in a downward biased valuation for stock option awards. The "lowball" valuation would systematically underreport compensation costs, thereby distorting company financial reports. The Council, therefore, has respectfully requested that the Office of the Chief Accountant prohibit Zions and all other public companies from using Zions ESOARS for financial reporting purposes unless and until the fundamental failings of the product have been remedied.

We look forward to continuing to work cooperatively with the SEC, this Subcommittee, and other interested parties to address these and other corporate governance issues relating to executive stock options. Our goal is to ensure that the issues are resolved in a manner that best serves the needs of investors and the US capital markets.

Thank you, Mr. Chairman for inviting me to participate at this hearing. I look forward to the opportunity to respond to any questions.



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Full Text of Statement

Chairman Levin, Ranking Member Coleman, and Members of the Subcommittee:

Good morning. I am Jeffrey P. Mahoney, general counsel, of the Council of Institutional Investors (“Council”). I am pleased to appear before you today on behalf of the Council. My testimony includes a brief overview of the Council followed by a discussion of some of the Council’s corporate governance “best practices” policies and recent activities relating to executive stock options.

The Council

The Council is a not-for-profit association of more than 135 public, labor and corporate pension funds with assets exceeding \$3 trillion. Council members are responsible for investing and safeguarding assets used to fund the pension benefits of millions of participants and beneficiaries throughout the United States (“US”).¹ Since the average Council member invests approximately 75 percent of its entire pension portfolio in US stocks and bonds, issues relating to US corporate governance, including issues relating to executive stock options, are of great interest to our members.

Council Corporate Governance Policies²

An important part of the Council’s activities involves the development of corporate governance policies. The policies set standards or recommended practices that the Council members believe companies and boards of directors should adopt. They are a living document that is constantly reviewed and updated.

¹ See Attachment 1 for a listing of the general members of the Council of Institutional Investors (“Council”).

² See Attachment 2 for the Council corporate governance policies.

The Council's policies neither bind members nor corporations. They are designed to provide guidelines that the Council has found to be appropriate in most situations.

Council staff uses the policies to determine whether and how the Council can respond to certain issues, including regulations proposed by the US Securities and Exchange Commission ("SEC" or "Commission"), accounting standards proposed by the standards setting bodies, and actions taken by publicly traded companies. Council policies also have been used to decide whether the Council should file an *amicus* brief in a lawsuit or help fund litigation. Council staff may without additional approval, take action on an issue that is within its policies and also within budgetary limits, although oversight of those actions by the Council's board is common.

The nine non-officers on the Council's board of directors serve as the policies committee and suggest subjects for policies, review staff policy drafts and decide which policies should be submitted to the full board.³ All general members of the Council are invited to submit ideas for policies to Council staff or Council directors.

The full board votes on whether to approve a proposed policy. Once approved by the board, the policy is either subject to a vote by the full membership at the next meeting or by mail ballot if the board believes time is of the essence.

³ See Attachment 3 for a list of the Council's board of directors.

Executive Compensation

Most of the Council's existing corporate governance policies address executive compensation issues.⁴ Executive compensation has long been a top priority for the Council and its members.

Concerns in recent years have centered not simply on the amount paid to chief executive officers and other top executives, but also on the board processes for setting pay, the disclosure of pay, and the structure of pay and the pay-for-performance metrics. Poorly structured pay packages, including executive stock option packages, may harm shareowner value by wasting owners' money, diluting ownership and creating inappropriate incentives that may damage a company's long-run performance.

The Council endorses reasonable, appropriately structured pay-for-performance programs that reward executives for sustainable, superior performance over the "long-term," consistent with a company's investment horizon and generally considered to be five or more years for mature companies and at least three years for other companies. While the Council believes that executives should be well paid for superior performance, it also believes that executives should not be excessively paid. It is the job of the board of directors and the compensation committee to ensure that executive compensation programs are effective, reasonable and rational with respect to critical factors such as company performance, industry considerations and compensation paid to other employees inside the company.

⁴ See Attachment 2, pages 7-16.

It is also the job of the compensation committee to ensure that elements of the executive compensation packages are appropriately structured to enhance the company's short- and long-term strategic goals and to retain and motivate executives to achieve those strategic goals. Compensation programs should not be driven by competitive surveys, which have become excessive and subject to abuse. The compensation committee should recognize that it is shareowners, not executives, whose money is at risk.

Since executive compensation must be tailored to meet unique company needs and situations, compensation programs must always be structured on a company-by-company basis. However, the Council believes that certain principles apply to all companies and all executive compensation programs.

Advisory Shareowner Votes on Executive Pay

One of those principles is that shareowners should be given a key role in executive compensation decision-making, including with respect to decisions involving executive stock options. On March 20, 2007, the Council's general members unanimously approved the following revision to the Council's corporate governance policies addressing this issue:

. . . [C]ompanies should provide annually for advisory shareowner votes on the compensation of senior executives.⁵

⁵ See Attachment 2, page 7.

In approving this policy, Council members generally agreed that an annual advisory shareowner vote on executive compensation would benefit investors and the capital markets for a number of reasons.⁶

Provides a mechanism for ongoing input on compensation

First, while investors have grown more concerned about perceived excesses and abuses of executive pay at US public companies, they have limited ability to signal their disapproval to boards or to shape pay policies. A December 2006 study by *The Corporate Library* found that the median total compensation for some 1,700 chief executive officers (“CEO’s”) nearly tripled from fiscal 1999 to 2005. Ninety percent of institutional investors think US executives are overpaid, according to a 2005 *Watson Wyatt* survey of 55 institutions managing a total of \$800 billion in assets.

While non-binding votes on executive pay practices are required in Australia, Sweden and the United Kingdom (“UK”), shareowners of US companies currently have no way to directly vote on all compensation matters. US stock exchanges mandate shareowner approval of equity-based compensation plans and investors must endorse performance criteria before companies can deduct compensation exceeding \$1 million, but compensation committees have substantial leeway in setting yearly performance targets and granting awards. Investors at US companies currently do not have a mechanism to provide ongoing input on how a company’s general compensation policies are applied to individual pay packages.

⁶ See Attachment 4, pages 2-4.

Provides a less blunt instrument than withholding support from directors

Second, shareowners can and do withhold support from compensation committee members standing for re-election, but withhold campaigns can be a blunt instrument for registering dissatisfaction with the committee's administration of pay plans and policies. The tactic can threaten the position of directors "who may very well have argued against the issue which causes shareholder concern, and often puts management in the position of having to defend individual directors," says Bess Joffe, manager for the Americas at *Hermes Equity Ownership Services*. She added, "[t]hese situations tend to escalate and become quite personal, ultimately distracting from the issue at hand."

Non-binding shareowner votes on executive pay might deter votes against directors since shareowners would have a "more specific and accurate place on the proxy to communicate concerns over pay," says Elizabeth McGeeveran, vice president for governance and socially responsible investment at *F&C Asset Management* ("F&C"). Of course, if a compensation committee failed to respond to an advisory vote that showed significant shareowner disapproval of pay practices, "investors might vote against committee members the following year," says Daniel Summerfield, investment adviser to the *Universities Superannuation Scheme*, one of the UK's largest pension funds.

Positive results in the UK

Finally, UK regulations requiring advisory shareowner votes on executive compensation went into effect in 2002, and have resulted in "better disclosure, better

and more dialogue between shareholders and companies, and more thought put into remuneration policy by directors,” according to David Paterson, research director of UK-based *Research, Recommendations and Electronic Voting*, a proxy advisory service. British drug maker *GlaxoSmithKline* (“GSK”) is a case-in-point. In 2003, 51 percent of GSK shareowners protested the CEO’s golden parachute package by either voting against or abstaining from voting on the company’s remuneration report. Stunned, the GSK board held talks with shareowners and the next year reduced the length of executive contracts and set new performance targets, muting investor criticism. Other UK companies got the message and now routinely seek investor input on compensation policies.

There is no guarantee that all the benefits attained from advisory shareowner votes on executive pay in the UK would be realized in the US. Stock ownership is far more concentrated in the UK, and British institutional investors have a strong tradition of standing up to company management and boards. As a result, UK boards are more inclined to take investor concerns about pay seriously. Even so, advisory shareowner votes—by their very nature—would benefit investors in US companies by providing a clear and direct way to communicate their views on executive compensation. “Voting results could also give directors leverage to resist executives’ demands for lavish rewards,” adds McGeeveran of F&C.

In summary, the Council believes that an annual shareowner advisory vote on executive compensation would efficiently and effectively provide boards with useful information about whether investors view the company’s compensation practices to be in shareowners’ best interests. Nonbinding shareowner votes on pay would serve as a

direct referendum on the decisions of the compensation committee, and would offer a more targeted way to signal shareowner discontent than withholding votes from committee members.

Executive Stock Options

Executive stock options have long been an important element of total executive compensation, particularly for CEO's.⁷ The Council believes that executive stock option programs can lead to superior company performance when the stock options are performance-based and structured to achieve appropriate long-term objectives that align executives' interests with those of the shareowners.

Preferred Structure

The Council's corporate governance policies set forth the preferred structure and practices for executive stock option awards and other long-term incentive compensation.⁸ The structure and practices include the following features:

Performance-based

Stock option award prices should be indexed to peer groups, performance-vesting and/or premium-priced to reward superior performance based on the attainment of challenging quantitative goals.

⁷ See, e.g., Eduardo Porter, *More Than Ever, It Pays to Be the Top Executive*, N.Y. Times, May 25, 2007, at 3, http://www.nytimes.com/2007/05/25/business/25execs.html?_r=1&oref=slogin&pagewanted=print (“As for the gap between C.E.O. pay and that of executives working under them, one reason may be that the larger share of stock options in top executives’ compensation packages these days makes the gap widen when the market is rising, as it was in the late 1990s and generally these days.”).

⁸ See Attachment 2, pages 11 & 13.

Dividend equivalents

To ensure that executives are neutral between dividends and stock price appreciation, dividend equivalents should be granted with stock option awards, but distributed only upon exercise of the option.

Size of awards

Compensation committees should set appropriate limits on the size of stock option awards granted to executives. So-called “mega-awards” or outsized awards should be avoided except in extraordinary circumstances, because they may result in rewards that are disproportionate to performance.

Vesting requirements

Meaningful performance periods and/or cliff vesting requirements—consistent with a company’s investment horizon, but no less than three years—should attach to all stock option awards, followed by pro rata vesting over at least two subsequent years for senior executives.

Grant timing

Except in extraordinary circumstances, such as a permanent change in performance cycles, stock option awards should be granted at the same time each year. Companies should not coordinate stock option grants with the release of material non-public information. The grants should occur whether recently publicized information is positive or negative, and stock option awards should never be backdated.

Hedging

Compensation committees should prohibit executives and directors from hedging (by buying puts and selling calls or employing other risk-minimizing techniques) stock option awards.

Proxy Statement Disclosures

Full and clear proxy statement disclosure of executive stock option awards and all other forms of compensation is of significant interest to the Council and its members because it enables shareowners to evaluate the performance of the compensation committee and board in setting executive pay and the pay-for-performance links. The Council's policies provide three principles relevant to proxy statement disclosures of executive stock options and all other forms of compensation.⁹

Philosophy/Strategy

First, compensation committees should have a well-articulated philosophy and strategy for executive stock option awards, which should be fully and clearly disclosed in the annual proxy statement.

Award Specifics

Compensation committees should disclose the size, distribution, vesting requirements, other performance criteria and grant timing of stock option awards granted to the executive oversight group and how the awards contribute to long-term performance objectives of a company.

⁹ See Attachment 2, page 11-12.

Ownership Targets

Finally, compensation committees should disclose whether and how executive stock option awards may be used to satisfy meaningful stock ownership requirements. Disclosure should include whether compensation committees impose post-exercise holding periods or other requirements to ensure that stock option awards are appropriately used to meet ownership targets.

SEC Rules on Executive Compensation and Related Party Disclosure

In light of the Council's three principles and other policies on proxy statement disclosures, we are generally supportive of the Commission's new rules on Executive Compensation and Related Party Disclosure.¹⁰ We are particularly pleased with the new (1) compensation and analysis section that requires enterprises to discuss, in plain English, the compensation committee's overall pay philosophy, practices and goals, and (2) related guidance regarding disclosure of stock option granting practices, particularly the required disclosure of the timing of option grants, the relationship between option grants and the release of material non-public information, and the determination of option exercise prices. These and many other provisions of the Commission's final rule were directly responsive to the Council's recommendations.¹¹

¹⁰ Executive Compensation and Related Person Disclosure, Securities Act Release No. 8732A, Exchange Act Release No. 54302A, Investment Company Release No. 27444A, 71 Fed. Reg. 53,158 (Sept. 8, 2006).

¹¹ See Attachment 4, pages 30-52.

We, however, remain disappointed with the Commission's December 2006 amendments to the final rule¹² that substantially changed how executive stock options and other equity-based awards are recognized in the new summary compensation table.¹³ Under the original final rule, a company would have had to report in the new summary compensation table the total fair value of stock option or equity-based grants made in a given year. Under the December amendments, however, the total fair value amount has been replaced in the summary compensation table by the accounting expense—the portion of the fair value of the grant made in a given year that is recognized as a compensation cost in the company's financial reports. The reporting of the total fair value of the award has been relegated to a less significant table.

The basis for our opposition to the December change is consistent with the Commission's stated basis for rejecting such an approach in developing the original final rule:

Disclosing these awards as they are expensed for financial statement reporting purposes would not mirror the timing of disclosure of non-equity incentive plan compensation. While we have imported a financial statement reporting principle to enable disclosure of compensation costs, executive compensation disclosure *must continue to inform investors of current actions regarding plan awards – a function that would not be fulfilled applying financial reporting recognition timing.*¹⁴

Moreover, the December change can create confusion and result in information of limited usefulness “where the change in market value of an award classified as a liability award is negative, or where it becomes unlikely that the performance condition

¹² Executive Compensation Disclosure, Securities Act Release No. 8765, Exchange Act Release No. 55009, 71 Fed. Reg. 78,338 (Dec. 29, 2006).

¹³ See Attachment 4, pages 22-26.

¹⁴ Executive Compensation and Related Person Disclosure, *supra* note 10, at 53,172 (emphasis added).

of a previously recognized performance-based award will be achieved.”¹⁵ In those and other circumstances, compensation cost for accounting purposes may be required to be reduced or reversed potentially resulting in *negative numbers* in the summary compensation table.

As one example, *The New York Times* recently reported that the summary compensation table contained in the proxy statement for Brookfield Homes, a home builder operating in California and Washington, D.C., reported that Ian G. Cockwell, Brookfield’s chief executive, made a negative \$2.3 million last year.¹⁶ Mr. Cockwell, however, received \$620,000 in cash and bonus in 2006, \$170,000 in other compensation (mostly dividends on his stockholdings), \$4.2 million in option gains and \$2.9 million in realized deferred stock gains.¹⁷ Shane D. Pearson, vice president and secretary at Brookfield Homes explains:

‘New S.E.C. requirements require us to put in this column the amounts we recognize for financial statements, Where I think people might get confused is they are used to seeing the grant date fair values.’¹⁸

The Council also remains disappointed with the process the Commission used to enact the December amendments. The proposed amendments, described by securities law experts as a “surprise move,”¹⁹ became effective the same date the proposal appeared in the Federal Register for public comment—*thirty-one days before the comment period closed*. The inability to effectively comment was particularly disconcerting when (1)

¹⁵ Securities Client Advisory, David B.H. Martin & David H. Engvall, Covington & Burling LLP, SEC Amends Disclosure Rules for Stock-Based Compensation 5 (Dec. 28, 2006) (available at www.cov.com).

¹⁶ Gretchen Morgenson, *Weird and Weirder Numbers on Pay Reports*, N.Y. Times, March 11, 2007, at 1, <http://select.nytimes.com/2007/03/11/business/yourmoney/11gret.html?ref=business>.

¹⁷ *Id.*

¹⁸ *Id.* at 2.

¹⁹ Martin & Engvall, *supra* note 15, at 1.

investors publicly supported the requirements in the original rule that were amended; (2) investors did not request the amendments; and (3) the amended rules indicated that the Commission concluded that the amendments would benefit investors.

As the 2007 proxy season continues, Council members are also paying special attention to the new disclosures that companies are required to provide about the performance targets that executives must meet to receive bonus payouts. Under the new rules, companies are allowed to exclude information about these targets if revealing those details would cause competitive harm.

The Council is concerned that companies are using the new rules' exclusion far too liberally. A recent analysis by the compensation consulting firm *Watson Wyatt* appears to confirm those concerns.²⁰ The analysis found that 46 percent of proxy statements reviewed did not disclose specific financial goals for their annual incentive plans.²¹

The Council is also concerned that the new rules do not require compensation committees to reveal much information about other services that their compensation consultants may provide. Consultants hired by the board of directors who also provide services to management face an inherent conflict of interest that may be detrimental to shareholder interests.

In October 2006, a large group of Council members sent letters to the compensation committee chairs of the 25 largest US companies (by market capitalization) in the S&P 500 asking for detailed information about services performed by outside compensation

²⁰ Press Release, *Watson Wyatt*, Specific Executive Pay Goals Often Omitted From Proxy Statements, *Watson Wyatt Analysis Finds* (Mar. 28, 2007), <http://www.watsonwyatt.com/news/press.asp?ID=17222>.

²¹ *Id.*

consultants.²² The letters also urged the committee chairs to adopt formal policies to prevent compensation consultants from working for both management and the board.

More recently, the Council's general members unanimously approved a revision to the Council's corporate governance policies addressing compensation advisers. That policy states, in part:

The compensation committee should develop and disclose a formal policy on compensation adviser independence. In addition, the committee should annually disclose an assessment of its advisers' independence, along with a description of the nature and dollar amounts of services commissioned from the advisers and their firms by the client company's management.²³

The Council believes that the disclosure described in our policy will, if adopted, better enable shareowners to assess the independence of the compensation committee's adviser.

The Council applauds the SEC staff for publicly acknowledging and agreeing with many, if not most, of the concerns that the Council and other investors have to-date raised about the initial implementation of the new rules.²⁴ The SEC staff has indicated that they are initiating a "review project" that will result in a report this fall that analyzes the first year compliance with the new rules.²⁵ We look forward to reviewing and commenting on the report.

²² Letter from Denise L. Nappier, Treasurer, State of Connecticut et al. to Compensation Committee Chair (Oct. 23, 2006), <http://www.state.ct.us/ott/pressreleases/press2006/pr102306letter.pdf>.

²³ See Attachment 2, page 9.

²⁴ Michael Bologna, *New SEC 'Review Project' Targets Compliance Rules*, 86 Bureau Nat'l Aff. A-11-12 (May 4, 2007).

²⁵ *Id.* at A-11.

Financial Accounting and Reporting

The Council has been, and continues to be, a strong proponent of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* (“Statement 123R”). Statement 123R, which became effective for most companies in 2006, significantly improves financial reporting by requiring that, consistent with the Council’s corporate governance policies,²⁶ all stock option awards be accounted for as compensation costs appropriately reducing reported earnings.

Statement 123R eliminated a “loophole” in financial reporting that was exploited by many companies, particularly technology companies, beginning in the 1990’s.²⁷ That loophole permitted companies to avoid the reporting of compensation costs in their earnings statements if the compensation took the form of a special type of stock option commonly referred to as a “fixed-price” stock option.

A fixed-price stock option had to meet certain criteria to qualify for the loophole including (1) the strike price is fixed and not below the grant-date market price, and (2) the expiration date is fixed. As described by one prominent consultant:

Through this strange but very tempting little loophole, truckloads of option grants were delivered to executives with no expense to the companies granting them. Because of this same loophole, hundreds of billions of dollars of shareholder value were transferred to executives with virtually no controls or limitations.²⁸

²⁶ See Attachment 2, page 13.

²⁷ See, e.g., Donald P. Delves, *Stock Options & The New Rules of Corporate Accountability* 6 (Dan Cafro ed., WorldatWork) (2006).

²⁸ *Id.* at 8.

The Financial Accounting Standards Board (“FASB”) initially attempted but failed to eliminate the loophole in the 1990’s. In Congressional testimony, Dennis R. Beresford, who was the Chairman of the FASB from 1987-1997 explained:

As many of you may recall, the FASB had proposed that companies account for the expense represented by the fair value of stock options granted to officers and employees. The business community and accounting firms strongly opposed this proposal and a number of corporations engaged in a lobbying effort to stymie the FASB’s initiative.

Certain members of Congress were sufficiently influenced by the appeals from corporate executives that they were persuaded to introduce legislation to counter the FASB’s proposal. The legislation would have prohibited public companies from following any final FASB rule on this matter. More importantly, the legislation would have imposed requirements that the SEC repeat the FASB’s process on any new accounting proposals, thus effectively eviscerating the FASB. Faced with the strong possibility that its purpose would have been eliminated by this legislation, the FASB made a strategic decision to require companies to disclose the effect of stock options in a footnote to the financial statements but not record the expense in the income statement.²⁹

The loophole had many negative effects for investors. For example, the loophole led to the excessive use of fixed-price stock options to the exclusion of other forms of stock options and other forms of compensation that are more closely related to long-term performance.³⁰ Fixed-price options rewarded executives for stock price increases due

²⁹ Accounting and Investor Protection Issues Raised by Enron and Other Public Companies: Oversight of the Accounting Profession, Audit Quality and Independence, and Formulation of Accounting Principles Before the S. Comm. on Banking, Housing, and Urban Affairs, 107th Cong. 4 (Feb. 26, 2002) (Prepared Statement of Dennis R. Beresford, Chairman, Financial Accounting Standards Board (“FASB”) 1987-97). Of note, Permanent Subcommittee on Investigations Chairman Levin was the most consistent and active Member of Congress supporting the independence of the FASB and the FASB’s efforts to improve the accounting for stock options.

³⁰ See, e.g., The Conference Board, Commission on Public Trust and Private Enterprise. Findings and Recommendations, Part I: Executive Compensation 7 (Sept.17, 2002).

entirely to market- or industry wide trends and, therefore, generally proved to be ineffective incentives to encourage and reward meaningful and sustainable corporate performance.³¹

In addition, excessive use of the loophole distorted reported profitability and other key financial metrics. The distortion created an unlevelled playing field that inappropriately favored companies that were the greatest users of fixed-price stock options. The result was a diversion of investment and capital resources away from their most efficient employment to the detriment of investors and other capital market participants.³²

Ironically, over 200 companies that took advantage of the loophole did not always qualify for the loophole because they backdated stock option grants making those options ineligible to be fixed-price stock options under the then-existing accounting requirements. The stock options backdating activities appear to have been motivated by a number of factors, including the desire to provide extra compensation to certain executives without: (1) requiring any performance from the executives in return for the extra compensation; (2) requesting approval or even informing existing or potential shareowners that the extra compensation was being granted; and (3) reporting the extra compensation as a cost or expense, and thereby overstating the company's profitability to market participants.

The Council believes that the stock option backdating scandal provides evidence that the financial accounting and reporting for executive stock options is an area in which

³¹ See, e.g., Delves, *supra* note 27, at 8.

³² See, e.g., Alan Greenspan, Chairman, Fed. Reserve Board, Remarks at the 2002 Financial Markets Conference of the Federal Reserve Bank of Atlanta, Sea Island, Ga. 5-6 (May 3, 2002).

there is a high risk of misapplication of reporting requirements. To-date about 100 companies have indicated that they must restate previously reported financial reports and the total amount of restatements, revisions and charges exceeds \$12 billion.³³ The Council, therefore, advocates that audit committees, external auditors, the Public Company Accounting Oversight Board and the Commission should all actively support the high-quality implementation of Statement 123R's principles-based requirements so that the reporting benefits of the new requirements are fully realized.³⁴

In that regard, staff of the Council and the CFA Institute Centre for Financial Market Integrity (an organization representing 90,000 investment professionals in 134 countries) recently met with staff of SEC's Office of the Chief Accountant ("OCA"). The purpose of the meeting was to discuss investor concerns about the potential use in financial reports of prices Zions Bancorporation ("Zions") has received in its recent offerings of a financial instrument they developed and named "Employee Stock Option Appreciation Rights" ("ESOARS"). Zions has proposed that the auction clearing price for its ESOARS qualify as a market-based approach for valuing stock option awards as permitted under Statement 123R. Zions plans to use ESOARS to not only value its own stock option awards, but to market the ESOARS approach to other companies for reporting purposes.

After consulting with leading valuation and accounting experts, and retaining a firm specializing in the valuation of stock options to evaluate Zions ESOARS,³⁵ the Council

³³ Otis Bilodeau, *SEC Settles With Brocade Over Options Backdating, People Say*, Bloomberg.com, May 31, 2007, at 1, <http://www.bloomberg.com/apps/news?pid=20601087&sid=aP0K.RTfzYfI&refer=home>.

³⁴ See Attachment 4, page 21.

³⁵ See Attachment 4, pages 9-18.

has concluded that, as presently constructed, Zions ESOARS result in a downward biased valuation that would underreport to investors the true costs of a company's stock option awards. The Council, therefore, has respectfully requested that the OCA prohibit Zions and all other public companies from using Zions ESOARS to value stock option awards under Statement 123R unless and until the fundamental failings of the product have been remedied.³⁶

We look forward to continuing to work cooperatively with the SEC, this Subcommittee, and other interested parties to address corporate governance issues relating to executive stock options. Our goal is to ensure that the issues are resolved in a manner that best serves the needs of investors and the US capital markets.

Thank you, Mr. Chairman for inviting me to participate at this hearing. I look forward to the opportunity to respond to any questions.

³⁶ See Attachment 4, page 7.



**Testimony of
Jeffrey P. Mahoney
General Counsel
Council of Institutional Investors
before the
Permanent Subcommittee on Investigations
of the
Committee on Homeland Security and Governmental Affairs
June 5, 2007**

Attachment 1

General Members

Council of Institutional Investors

General Members*

Last Updated: August 15, 2006

AFL-CIO Pension Plan

AFSCME Employees Pension Plan

Agilent Technologies Benefit Plans

Alameda County Employees' Retirement Association

Alaska Permanent Fund Corporation

Altria Corporate Services Pension Plan

American Federation of Teachers Pension Plan

Arkansas Public Employees Retirement System

Arkansas Teacher Retirement System

BP America

Bricklayers & Trowel Trades Pension Fund

Building Trades Pension Trust Fund -Milwaukee and Vicinity

California Public Employees' Retirement System

California State Teachers' Retirement System

Campbell Soup Retirement & Pension Plans

Carpenters United Brotherhood Local Unions & Councils Pension Fund

Carpenters Pension Fund Chicago District Council

CERES Defined Contribution Retirement Plan

ChevronTexaco

*General membership in the Council is open to any employee benefit plan, state or local agency officially charged with the investment of plan assets, or non-profit endowment funds and non-profit foundations. General Members participate in all meetings and seminars sponsored by the Council and are the only voting members of the Council. Annual dues are \$1.30 per \$1 million in fund assets, but no less than \$3,000 and no more than \$30,000.

CIGNA Pension Fund

Coca-Cola Retirement Plan

Colgate-Palmolive Employees' Retirement Income Plan

Colorado Fire and Police Pension Association

Colorado Public Employees' Retirement Association

Communications Workers of America Pension Fund

Connecticut Retirement Plans and Trust Funds

Contra Costa County Employees' Retirement Association

CWA/ITU Negotiated Pension Plan

Dallas Employees' Retirement Fund

Delaware Public Employees Retirement System

Detroit General Retirement System

Disney (Walt)

District of Columbia Retirement Board

ELCA Board of Pensions

Fairfax County Educational Employees' Retirement System

Fannie Mae

Florida State Board of Administration

Gap

General Mills Retirement Plan

General Motors Investment Management

Hartford Municipal Employees Retirement Fund

Hewlett-Packard

Houston Firefighters' Relief & Retirement Fund

I.A.M. National Pension Fund

IBEW Pension Benefit Fund

Idaho Public Employee Retirement System

Illinois State Board of Investment

Illinois State Universities Retirement System

Illinois Teachers' Retirement System

Iowa Municipal Fire & Police Retirement System

Iowa Public Employees Retirement System

ITT Industries Pension Fund Trust

IUE-CWA Pension Fund

Jacksonville Police and Fire Pension Fund

Jeffrey Company

Johnson & Johnson

Kentucky Retirement Systems

Kern County Employees' Retirement Association

KeyCorp Cash Balance Pension Plan

Laborers' Central Pension Fund

LIUNA Local Union & District Council Pension Fund

Los Angeles City Employees' Retirement System

Los Angeles County Employees Retirement Association

Los Angeles Fire and Police Pension System

Lucent Technologies Pension Plan

Maine State Retirement System

Marin County Employees' Retirement Association

Maryland, State Retirement Agency

Massachusetts Bay Transportation Authority Retirement Fund

Massachusetts PRIM

McDonald's Employee Benefits Plan

Microsoft

Milwaukee Employees' Retirement System

Minnesota State Board of Investment

Missouri Public School & Non-Teacher School ERS

Missouri State Employees' Retirement System

Montgomery County Employees' Retirement System

Nathan Cummings Foundation

National Education Association Retirement Plan

Navy-Marine Corps Relief Society

New Hampshire Retirement System

New Jersey Division of Investment

New York City Employees' Retirement System

New York City Pension Funds

New York City Board of Education Retirement System

New York City Fire Department Pension Fund

New York City Police Pension Fund

New York City Teachers' Retirement System

New York State and Local Retirement System

New York State Teachers' Retirement System

North Carolina Retirement System

Ohio Police & Fire Pension Fund

Ohio Public Employees Retirement System

Ohio School Employees Retirement System

Ohio State Teachers' Retirement System

Operating Engineers Central Pension Fund

Pennsylvania Public School Employees' Retirement System

Pennsylvania State Employees' Retirement System

Pfizer

Pitney Bowes Pension Plan

Plumbers & Pipefitters National Pension Fund

Producer-Writers Guild

Rhode Island Employees' Retirement System

Sacramento County Employees' Retirement System

San Diego City Employees' Retirement System

San Francisco City & County Employees' Retirement System

San Jose City Retirement Systems

Santa Barbara County Employees' Retirement System

Schering-Plough Employees' Savings Plan

Sealed Air Retirement Plans

SEIU Union Pension Fund

Sheet Metal Workers' Local 19 Pension Plan

Sheet Metal Workers' National Pension Fund

Sunoco

Target

Teamster Affiliates Pension Plan

Tennessee Consolidated Retirement System

Texas Employees Retirement System

Texas Municipal Retirement System

Texas Teacher Retirement System

UFCW Staff Trust Fund

UNITE HERE Laundry & Dry Cleaning Workers Pension Fund

UNITE HERE National Retirement Fund

UNITE HERE Textile Workers Pension Fund

United States Steel and Carnegie Pension Fund

Virginia Retirement System

Washington State Investment Board

West Virginia Investment Management Board

Wisconsin State Investment Board

World Bank Staff Retirement Plan

Xerox Corporation



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Attachment 2

Council Corporate Governance Policies

The Council of Institutional Investors Corporate Governance Policies

CONTENTS:

I. Introduction

II. The Board of Directors

III. Shareowner Voting Rights

IV. Shareowner Meetings

V. Executive Compensation

Role of Compensation Committee

Salary

Annual Incentive Compensation

Long-Term Incentive Compensation

Perquisites

Employment Contracts, Severance and Change-of-Control Payments

Retirement Arrangements

Stock Ownership

VI. Non-Employee Director Compensation

VII. Independent Director Definition

I. Introduction

The Council expects that corporations will comply with all applicable federal and state laws and regulations and stock exchange listing standards.

The Council believes every company should also have written disclosed governance procedures and policies, an ethics code that applies to all employees and directors, and provisions for its strict enforcement. The Council posts its corporate governance policies on its web site (www.cii.org); it hopes corporate boards will meet or exceed these standards and adopt similarly appropriate additional policies to best protect shareowners' interests.¹

In general, the Council believes that corporate governance structures and practices should protect and enhance accountability to, and ensure equal financial treatment of, shareowners. An action should not be taken if its purpose is to reduce accountability to shareowners.

The Council also believes shareowners should have meaningful ability to participate in the major fundamental decisions that affect corporate viability, and meaningful opportunities to suggest or nominate director candidates and to suggest processes and criteria for director selection and evaluation.

¹ At the February 2006 meeting of the Council's Policies Committee, it was decided that Council policies should use the term "shareowner" instead of "shareholder," reflecting the Council's belief that the former term is a better descriptor.

The Council believes companies should adhere to responsible business practices and practice good corporate citizenship. Promotion, adoption and effective implementation of guidelines for the responsible conduct of business and business relationships are consistent with the fiduciary responsibility of protecting long-term investment interests.

The Council believes good governance practices should be followed by publicly traded companies, private companies and companies in the process of going public. As such, the Council believes that, consistent with their fiduciary obligations to their limited partners, the general members of venture capital, buyout and other private equity funds should use appropriate efforts to encourage companies in which they invest to adopt long-term corporate governance provisions that are consistent with the Council's policies.

The Council believes that U.S. companies should not reincorporate offshore because corporate governance structures there are weaker and therefore reduce management accountability to shareowners.

Council policies neither bind members nor corporations. They are designed to provide guidelines that the Council has found to be appropriate in most situations.

II. The Board of Directors

Annual election of directors. All directors should be elected annually (no classified boards).

Director elections: When permissible under state law, companies' charters and by-laws should provide that directors in uncontested elections are to be elected by a majority of the votes cast. In contested elections, plurality voting should apply. An election is contested when there are more director candidates than there are available board seats. Boards should adopt policies asking that directors tender their resignations if they fail to win majority support in uncontested elections, and providing that such directors will not be renominated after expiration of their current term in the event they fail to tender such resignation.

Independent board. At least two-thirds of the directors should be independent (i.e., their only non-trivial professional, familial or financial connection to the corporation, its chairman, CEO or any other executive officer is their directorship). The company should disclose information necessary for shareowners to determine whether directors qualify as independent, whether or not the disclosure is required by state or federal law. This information should include all financial or business relationships with and payments to directors and their families and all significant payments to companies, non-profits, foundations and other organizations where company directors serve as employees, officers or directors. (See Council definition of independent director.)

All-independent board committees. Companies should have audit, nominating and compensation committees, and all members of these committees should be independent. The board (not the CEO) should appoint the committee chairs and members. Committees

should be able to select their own service providers. Some regularly scheduled committee meetings should be held with only the committee members (and, if appropriate, the committee's independent consultants) present. The process by which committee members and chairs are selected should be disclosed to shareowners.

Board accountability to shareowners

Majority shareowner votes. Boards should take actions recommended in shareowner proposals that receive a majority of votes cast for and against. If shareowner approval is required for the action, the board should submit the proposal to a binding vote at the next shareowner meeting.

Interaction with shareowners. Directors should respond to communications from shareowners and should seek shareowner views on important governance, management and performance matters. All directors should attend the annual shareowners' meeting and be available, when requested by the chair, to answer shareowner questions.

Shareowner – director communication, interaction & meeting conduct. Directors should respond to communications from shareowners and should seek shareowner views on important governance, management and performance matters. To accomplish this goal, all companies should establish a mechanism by which shareowners with non-trivial concerns could communicate directly with all directors, including independent directors. Policies requiring that all director communication go through a member of the management team should be avoided unless they are for record-keeping purposes. In such cases, procedures documenting receipt, delivery to the board and response must be maintained and made available upon request to shareowners.

During the annual general meeting, shareowners should have the right to ask questions, both orally and in writing, and expect answers and discussion where appropriate from the board of directors. Such discussion should take place regardless whether those questions have been submitted in advance. All directors should attend the annual shareowners' meetings and be available, when requested by the chair, to answer shareowner questions. While reasonable time limits to questions asked might be acceptable, the board should not ignore or skip hearing questions because a shareowner has a smaller number of shares or has not held those shares for a certain amount of time.

Independent chair/lead director. The board should be chaired by an independent director. The CEO and chair roles should only be combined in very limited circumstances; in these situations, the board should provide a written statement in the proxy materials discussing why the combined role is in the best interests of shareowners, and it should name a lead independent director who should have approval over information flow to the board, meeting agendas, and meeting schedules to ensure a structure that provides an appropriate balance between the powers of the CEO and those of the independent directors.

Other roles of the lead independent director should include chairing meetings of nonmanagement directors and of independent directors, presiding over board meetings in the absence of the chair, serving as the principle liaison between the independent directors and the chair, and leading the board/director evaluation process. Given these

additional responsibilities, the lead independent director should expect to devote a greater amount of time to board service than the other directors.

Board/director evaluation. Boards should evaluate themselves and their individual members on a regular basis. Board evaluation should include an assessment of whether the board has the necessary diversity of skills, backgrounds, experiences, ages, races and genders appropriate to the company's ongoing needs. Individual director evaluations should include high standards for in person attendance at board and committee meetings and disclosure of all absences or conference call substitutions.

Boards should review the performance and qualifications of any director from whom at least 10 percent of the votes cast are withheld.

Absent compelling and stated reasons, directors who attend fewer than 75 percent of board and board-committee meetings for two consecutive years should not be renominated.

Companies should disclose individual director attendance figures for board and committee meetings. Disclosure should distinguish between in-person and telephonic attendance. Excused absences should not be categorized as attendance.

'Continuing directors.' Corporations should not adopt so-called "continuing director" provisions (also known as "dead-hand" poison pills) that allow former directors who have left office to take action on behalf of the corporation.

Board size and service. Absent compelling, unusual circumstances, a board should have no fewer than 5 and no more than 15 members (not too small to maintain the needed expertise and independence, and not too large to be efficiently functional). Shareowners should be allowed to vote on any major change in board size.

Companies should establish and publish guidelines specifying on how many other boards their directors may serve. Absent unusual, specified circumstances, directors with full-time jobs should not serve on more than two other boards. Currently serving CEOs should only serve as a director of one other company, and then only if the CEO's own company is in the top half of its peer group. No person should serve on more than five for-profit company boards.

Board operations. Directors should receive training from independent sources on their fiduciary responsibilities and liabilities. Directors have an affirmative obligation to become and remain independently familiar with company operations; they should not rely exclusively on information provided to them by the CEO to do their jobs.

Directors should be provided meaningful information in a timely manner prior to board meetings, and should be allowed reasonable access to management to discuss board issues. Directors should be allowed to place items on board agendas.

Non-management directors should hold regularly scheduled executive sessions without the CEO or staff present. The independent directors should also hold regularly scheduled in-person executive sessions without non-independent directors and staff present.

The board should approve and maintain a CEO succession plan.

Auditor independence. As prescribed by law, the audit committee has the responsibility to hire, oversee and, if necessary, fire the company's outside auditor.

The audit committee should seek competitive bids for the external audit engagement no less frequently than every five years.

The company's external auditor should not perform any non-audit services for the company, except those required by statute or regulation to be performed by a company's external auditor, such as attest services.

The proxy statement should also include a copy of the audit committee charter and a statement by the audit committee that it has complied with the duties outlined in the charter.

Companies should not agree to limit the liability of outside auditors.

Audit committee charters should provide for annual shareowner votes on the board's choice of independent, external auditor. Such provisions ought to state that if the board's selection fails to achieve the support of a majority of the for-and-against votes cast, the audit committee should: (1) take the shareowners' views into consideration and reconsider its choice of auditor; and (2) solicit the views of major shareowners in order to determine why broad levels of shareowner support were not achieved.

Charitable and political contributions. The board of directors should monitor, assess and approve all charitable and political contributions (including trade association contributions) made by the company. The board should ensure that only contributions consistent with and aligned to the interests of the company and its shareowners are approved. The terms and conditions of such contributions should be clearly defined and approved by the board. The board's guidelines for contribution approval should be publicly disclosed as a corporate contributions policy.

The board should disclose on an annual basis the amounts and recipients of all monetary and non-monetary contributions made by the company during the prior fiscal year. If any expenditures earmarked for political or charitable activities were provided to or through a third-party, then those expenditures should be included in the report.

III. Shareowner Voting Rights

The shareowners' right to vote is inviolate and should not be abridged.

Access to the proxy. Companies should provide access to management proxy materials for a long-term investor or group of long-term investors owning in aggregate at least 5 percent of a company's voting stock to nominate less than a majority of the directors. Eligible investors must have owned the stock for at least three years. Company proxy materials and related mailings should provide equal space and equal treatment of nominations by qualifying investors.

One share, one vote. Each share of common stock should have one vote. Corporations should not have classes of common stock with disparate voting rights. Authorized unissued common shares that have voting rights to be set by the board should not be issued with unequal voting rights without shareowner approval.

Confidential voting. All proxy votes should be confidential, with ballots counted by independent tabulators. Confidentiality should be automatic and permanent and apply to all ballot items. Rules and practices concerning the casting, counting and verifying of shareowner votes should be clearly disclosed.

Voting requirements. A majority vote of common shares outstanding should be sufficient to amend company bylaws or take other action requiring or receiving a shareowner vote. Supermajority votes should not be required.

A majority vote of common shares outstanding should be required to approve:

*Major corporate decisions concerning the sale or pledge of corporate assets that would have a material effect on shareowner value. Such a transaction will automatically be deemed to have a material effect if the value of the assets exceeds 10 percent of the assets of the company and its subsidiaries on a consolidated basis.

*The corporation's acquiring 5 percent or more of its common shares at above-market prices other than by tender offer to all shareowners.

*Poison pills.

*Abridging or limiting the rights of common shares to (i) vote on the election or removal of directors or the timing or length of their term of office, or (ii) make nominations for directors or propose other action to be voted on by shareowners, or (iii) call special meetings of shareowners or take action by written consent or affect the procedure for fixing the record date for such action.

*Provisions resulting in the issuance of debt to a degree that would excessively leverage the company and imperil the long-term viability of the corporation.

Broker votes. Broker non-votes and abstentions should be counted only for purposes of a quorum.

Bundled voting. Shareowners should be allowed to vote on unrelated issues separately. Individual voting issues, particularly those amending a company's charter, bylaws or anti-takeover provisions, should not be bundled.

IV. Shareowner Meetings

Corporations should make shareowners' expense and convenience primary criteria when selecting the time and location of shareowner meetings.

Appropriate notice of shareowner meetings, including notice concerning any change in meeting date, time, place or shareowner action, should be given to shareowners in a manner and within time frames that will ensure that shareowners have a reasonable opportunity to exercise their franchise. Polls should remain open at shareowner meetings until all agenda items have been discussed and shareowners have had an opportunity to ask and receive answers to questions concerning them.

Companies should not adjourn a meeting for the purpose of soliciting more votes to enable management to prevail on a voting item. Extending a meeting should only be done for compelling reasons such as vote fraud, problems with the voting process or lack of a quorum.

Companies should hold shareowner meetings by remote communication (so-called electronic or "cyber" meetings) only as a supplement to traditional in-person shareowner meetings, not as a substitute.

As noted in Section II, "The Board of Directors", all directors should attend the annual shareowners' meeting and be available, when requested by the chair, to respond directly to oral or written questions from shareowners.

V. Executive Compensation

The Council believes that executive compensation is a critical and visible aspect of a company's governance. Pay decisions are one of the most direct ways for shareowners to assess the performance of the board. And they have a bottom line effect, not just in terms of dollar amounts, but also by formalizing performance goals for employees, signaling the market and affecting employee morale.

The Council endorses reasonable, appropriately structured pay-for-performance programs that reward executives for sustainable, superior performance over the "long-term," consistent with a company's investment horizon and generally considered to be five or more years for mature companies and at least three years for other companies. While the Council believes that executives should be well paid for superior performance, it also believes that executives should not be excessively paid. It is the job of the board of directors and the compensation committee to ensure that executive compensation programs are effective, reasonable and rational with respect to critical factors such as company performance, industry considerations and compensation paid to other employees inside the company.

It is also the job of the compensation committee to ensure that elements of compensation packages are appropriately structured to enhance the company's short- and long-term strategic goals and to retain and motivate executives to achieve those strategic goals. Compensation programs should not be driven by competitive surveys, which have become excessive and subject to abuse. They should recognize that it is shareowners, not executives, whose money is at risk.

Since executive compensation must be tailored to meet unique company needs and situations, compensation programs must always be structured on a company-by-company basis. However, the Council believes that certain principles apply to all companies. For example, all companies should provide annually for advisory shareowner votes on the compensation of senior executives.

ROLE OF COMPENSATION COMMITTEE

The compensation committee is responsible for structuring executive pay, evaluating executive performance within the context of the pay structure of the entire company, subject to approval of the board of directors. To best handle this role, the Council believes that compensation committees should adopt the following principles and practices:

Structure

- **Committee composition:** All members of the compensation committee should be independent. Committee membership should rotate periodically among the board's independent directors. Members should be or take responsibility to become knowledgeable about compensation and related issues. They should exercise due diligence and independent judgment in carrying out their committee responsibilities. They should represent diverse backgrounds and professional experiences.

Responsibilities

- **Executive pay philosophy:** The compensation philosophy should be clearly disclosed to shareowners in annual proxy statements. In developing, approving and monitoring the executive pay philosophy, the compensation committee should consider the full range of pay components, including structure of programs, desired mix of cash and equity awards, goals for distribution of awards throughout the company, how executive pay relates to the pay of other employees, use of employment contracts, and policy regarding dilution.

- **Oversight:** The compensation committee should vigorously oversee all aspects of executive compensation for a group composed of the CEO and other highly paid executives, as required by law, and any other highly paid employees, including executives of subsidiaries, special purpose entities and other affiliates, as determined by the compensation committee. The committee should ensure that the structure of employee compensation throughout the company is fair, non-discriminatory and forward-looking, and that it motivates, recruits and retains a workforce capable of meeting the company's strategic objectives. To perform its oversight duties, the committee should approve, comply with and fully disclose a charter detailing its responsibilities.

- **Pay for performance:** Compensation of the executive oversight group should be driven predominantly by performance. The compensation committee should establish performance measures for executive compensation that are agreed to ahead of time and publicly disclosed. Performance measures applicable to all performance-based awards (including annual and long-term incentive compensation) should reward superior performance—based predominantly on total stock return measures and key operational measures—at minimum reasonable cost and should reflect downside risk.

- **Annual approval and review:** Each year, the compensation committee should review performance of individuals in the oversight group and approve any bonus, severance, equity-based award or extraordinary payment made to them. The committee should understand all components of executive compensation and annually review total compensation potentially payable to the oversight group under all possible scenarios, including death/disability, retirement, voluntary termination, termination with and without cause and changes of control. The committee should also ensure that the structure of pay at different levels (CEO and others in the oversight group, other executives and non-executive employees) is fair and appropriate in the context of broader company policies and goals and fully justified and explained.

- **Committee accountability:** In addition to attending all annual and special shareowner meetings, committee members should be available to respond directly to questions about executive compensation; the chair of the committee should take the lead. In addition, the committee should regularly report on its activities to the independent directors of the board, who should review and ratify committee decisions. Committee members should

take an active role in preparing the compensation committee report contained in the annual proxy materials, and be responsible for the contents of that report.

- **Outside advice:** The compensation committee should retain and fire outside experts, including consultants, legal advisers and any other advisers when it deems appropriate, including when negotiating contracts with executives. Individual compensation advisers and their firms should be independent of the client company, its executives and directors and should report solely to the compensation committee. The compensation committee should develop and disclose a formal policy on compensation adviser independence. In addition, the committee should annually disclose an assessment of its advisers' independence, along with a description of the nature and dollar amounts of services commissioned from the advisers and their firms by the client company's management. Companies should not agree to indemnify or limit the liability of compensation advisers or the advisers' firms.

Proxy statement disclosure

- **Disclosure practices:** The compensation committee is responsible for ensuring that all aspects of executive compensation are clearly, comprehensively and promptly disclosed, in plain English, in the annual proxy statement regardless of whether such disclosure is required by current rules and regulations. The compensation committee should disclose all information necessary for shareowners to understand how and how much executives are paid and how such pay fits within the overall pay structure of the company. It should provide annual proxy statement disclosure of the committee's compensation decisions with respect to salary, short-term incentive compensation, long-term incentive compensation and all other aspects of executive compensation, including the relative weights assigned to each component of total compensation. Other recommended disclosures relevant to specific elements of executive compensation are detailed below.

- **Benchmarking:** Benchmarking at median or higher levels is a primary contributor to escalating executive compensation. Although benchmarking can be a constructive tool for formulating executive compensation packages, it should not be relied on exclusively. If benchmarking is used, compensation committees should commit to annual disclosure of the companies in peer groups used for benchmarking and/or other comparisons. If the peer group used for compensation purposes is different from that used to compare overall performance, such as the five-year stock return graph required in the annual proxy materials, the compensation committee should describe the differences between the groups and the rationale for choosing between them. In addition to disclosing names of companies used for benchmarking and comparisons, the compensation committee should disclose targets for each compensation element relative to the peer/benchmarking group and year-to-year changes in companies composing peer/benchmark groups.

SALARY

Since salary is one of the few components of executive compensation that is not "at risk," it should be set at a level that yields the highest value for the company at least cost. In general, salary should be set to reflect responsibilities, tenure and past performance, and to be tax efficient—meaning no more than \$1 million. The compensation committee should publicly disclose its rationale for paying salaries above the median of the peer group.

ANNUAL INCENTIVE COMPENSATION

Cash incentive compensation plans should be structured to appropriately align executive interests with company goals and objectives and to reasonably reward superior performance that meets or exceeds well-defined and clearly disclosed performance targets that reinforce long-term strategic goals set and approved by the board and written down in advance of the performance cycle.

Structure

- **Formula plans:** The compensation committee should approve formulaic bonus plans containing specific qualitative and quantitative performance-based operational measures designed to reward executives for superior performance related to operational/strategic/other goals set by the board. Such awards should be capped at a reasonable maximum level. These caps should not be calculated as percentages of accounting or other financial measures (such as revenue, operating income or net profit), since these figures may change dramatically due to mergers, acquisitions and other nonperformance-related strategic or accounting decisions.
- **Targets:** When setting performance goals for “target” bonuses, the compensation committee should set performance levels below which no bonuses would be paid and above which bonuses would be capped.
- **Changing targets:** Except in unusual and extraordinary situations, the compensation committee should not “lower the bar” by changing performance targets in the middle of bonus cycles. If performance targets must be lowered, amended or changed in the middle of a performance cycle, reasons for the change and details of the initial targets and adjusted targets should be disclosed.

Proxy statement disclosure

- **Transparency:** The compensation committee should commit to provide full descriptions of the qualitative and quantitative performance measures and benchmarks used to determine annual incentive compensation, including the weightings of each measure. At the beginning of a period, the compensation committee should calculate and disclose the maximum compensation payable if all performance-related targets are met. At the end of the performance cycle, the compensation committee should disclose actual targets and details on the determination of final payouts.

Disgorgement

Executives should be required to repay incentive compensation to the company in the event of malfeasance involving the executive, or fraudulent or misleading accounting that results in substantial harm to the corporation.

Shareowner approval

Shareowners should approve the establishment of, any material amendments to, annual incentive compensation plans covering the oversight group.

LONG-TERM INCENTIVE COMPENSATION

Well-designed compensation programs can lead to superior performance. Long-term incentive compensation, generally in the form of equity-based awards, can be structured

to achieve a variety of long-term objectives, including retaining executives, aligning executives' financial interests with the interests of shareowners, and rewarding the achievement of long-term specified strategic goals of the company and/or the superior performance of company stock.

But long-term incentive compensation comes at a cost, and poorly structured awards permit excessive or abusive pay that is detrimental to the company and to shareowners. To maximize effectiveness and efficiency, compensation committees should carefully evaluate the costs and benefits of long-term incentive compensation, ensure that long-term compensation is appropriately structured and consider whether performance and incentive objectives would be enhanced if awards were distributed throughout the company, not simply to top executives.

Companies may rely on a myriad of long-term incentive vehicles—including, but not limited to, performance-based restricted stock/units, phantom shares, stock units and stock options—to achieve a variety of long-term objectives. While the technical underpinnings of long-term incentive awards may differ, the Council believes that the following principles and practices apply to all long-term incentive compensation awards. And, as detailed below, certain policies are relevant to specific types of long-term incentive awards.

Structure

- ***Size of awards***: Compensation committees should set appropriate limits on the size of long-term incentive awards granted to executives. So-called “mega-awards” or outsized awards should be avoided except in extraordinary circumstances, because they may result in rewards that are disproportionate to performance.
- ***Vesting requirements***: Meaningful performance periods and/or cliff vesting requirements—consistent with a company's investment horizon, but no less than three years—should attach to all long-term incentive awards, followed by pro rata vesting over at least two subsequent years for senior executives.
- ***Grant timing***: Except in extraordinary circumstances, such as a permanent change in performance cycles, long-term incentive awards should be granted at the same time each year. Companies should not coordinate stock award grants with the release of material non-public information. The grants should occur whether recently publicized information is positive or negative, and stock options should never be backdated.
- ***Hedging***: Compensation committees should prohibit executives and directors from hedging (by buying puts and selling calls or employing other risk-minimizing techniques) equity-based awards granted as long-term incentive compensation or other stock holdings in the company. And, they should strongly discourage other employees from hedging their holdings in company stock.

Proxy statement disclosure

- ***Philosophy/strategy***: Compensation committees should have a well-articulated philosophy and strategy for long-term incentive compensation, which should be fully and clearly disclosed in the annual proxy statement.
- ***Award specifics***: Compensation committees should disclose the size, distribution, vesting requirements, other performance criteria and grant timing of each type of long-

term incentive award granted to the executive oversight group and how each component contributes to long-term performance objectives of a company.

- **Ownership targets:** Compensation committees should disclose whether and how long-term incentive compensation may be used to satisfy meaningful stock ownership requirements. Disclosure should include whether compensation committees impose post-exercise holding periods or other requirements to ensure that long-term incentive compensation is appropriately used to meet ownership targets.

Disgorgement

Executives should be required to repay long-term incentive compensation to the company in the event of malfeasance involving the executive, or fraudulent or misleading accounting that results in substantial harm to the corporation.

Shareowner approval

Shareowners should approve all long-term incentive plans, including equity-based plans, any material amendments to existing plans or any amendments of outstanding awards to shorten vesting requirements, reduce performance targets or otherwise change outstanding long-term incentive awards to benefit executives. Plans should have expiration dates and not be structured as “evergreen,” rolling plans.

DILUTION

Dilution measures how much the additional issuance of stock may reduce existing shareowners’ stake in a company. Dilution is particularly relevant for long-term incentive compensation plans since these programs essentially issue stock at below-market prices to the recipients. The potential dilution represented by long-term incentive compensation plans is a direct cost to shareowners.

Dilution from long-term incentive compensation plans may be evaluated using a variety of techniques including, but not limited to, the reduction in earnings per share and voting power resulting from the increase in outstanding shares.

Proxy statement disclosure

- **Philosophy/strategy:** Compensation committees should develop and disclose the philosophy regarding dilution including definition(s) of dilution, peer group comparisons and specific targets for annual awards and total potential dilution represented by equity compensation programs for the current year and expected for the subsequent four years.

- **Stock repurchase programs:** Stock buyback decisions are a capital allocation decision and should not be driven solely for the purpose of minimizing dilution from equity-based compensation plans. The compensation committee should provide information about stock repurchase programs and the extent to which such programs are used to minimize the dilution of equity-based compensation plans.

- **Tabular disclosure:** The annual proxy statement should include a table detailing the overhang represented by unexercised options and shares available for award and a discussion of the impact of the awards on earnings per share.

STOCK OPTION AWARDS

Stock options give holders the right, but not the obligation, to buy stock in the future. Options may be structured in a variety of ways. The Council considers some structures and policies preferable because they more effectively ensure that executives are compensated for superior performance. Other structures and policies are inappropriate and should be prohibited.

Structure—preferred practices

- **Performance options:** Stock option prices should be indexed to peer groups, performance-vesting and/or premium-priced to reward superior performance based on the attainment of challenging quantitative goals.
- **Dividend equivalents:** To ensure that executives are neutral between dividends and stock price appreciation, dividend equivalents should be granted with stock options, but distributed only upon exercise of the option.
- **Stock option expensing:** Since stock options have a cost, companies should include these costs as an expense on their reported income statements and disclose valuation assumptions.

Structure—inappropriate practices

- **Discount options:** No discount options should be awarded.
- **Reload options:** Reload options should be prohibited.
- **Option repricing:** "Underwater" options should not be repriced or replaced (either with new options or other equity awards), unless approved by shareowners. Repricing programs, for shareowner approval, should exclude directors and executives, restart vesting periods and mandate value-for-value exchanges in which options are exchanged for a number of equivalently valued options/shares.

STOCK AWARDS/UNITS

Stock awards/units and similar equity-based vehicles generally grant holders stock based on the attainment of performance goals and/or tenure requirements. These types of awards are more expensive to the company than options, since holders generally are not required to pay to receive the underlying stock, and therefore should be limited in size.

Structure

Stock awards should be linked to the attainment of specified performance goals and in some cases to additional time-vesting requirements. Stock awards should not be payable based solely on the attainment of tenure requirements.

Proxy statement disclosure

- **Transparency:** The compensation committee should provide full descriptions of the qualitative/quantitative performance measures and benchmarks used and the weightings of each component. Whenever possible, disclosure should include details of performance targets.

PERQUISITES

Company perquisites blur the line between personal and business expenses. The Council believes that executives, not companies, should be responsible for paying personal expenses—particularly those that average employees routinely shoulder, such as family and personal travel, financial planning, club memberships and other dues. The compensation committee should ensure that any perquisites are warranted and have a legitimate business purpose, and it should consider capping all perquisites at a de minimis level. Total perquisites should be described, disclosed and valued.

EMPLOYMENT CONTRACTS, SEVERANCE AND CHANGE-OF-CONTROL PAYMENTS

Various arrangements may be negotiated to outline terms and conditions for employment and to provide special payments following certain events, such as a termination of employment with/without cause and/or a change in control. The Council believes that these arrangements should be used on a limited basis.

Structure

- ***Employment contracts***: Companies should only provide employment contracts to executives in limited circumstances, such as to provide modest, short-term employment security to a newly hired or recently promoted executive. Such contracts should have a specified termination date (not to exceed three years); contracts should not be “rolling” on an open-ended basis.
- ***Severance payments***: Executives should be entitled to severance payments in non-control change situations only in the event of wrongful termination, death or disability. Termination for poor performance, resignation under pressure or failure to renew the contract should not qualify as wrongful termination.
- ***Change-in-control payments***: Any provisions providing for compensation following a change-in-control event should be “double-triggered,” stipulating that compensation is payable only (1) after a control change actually takes place and (2) if a covered executive's job is terminated because of the control change.

Limitations

- ***Gross-ups***: Companies should not compensate executives for any excise or additional taxes payable upon the receipt of severance, change-in-control or similar payments.

Proxy statement disclosure

- ***Transparency***: The compensation committee should fully and clearly describe the terms and conditions of employment contracts and any other agreements/arrangements covering the executive oversight group and reasons why the compensation committee believes the agreements are in the best interests of shareowners.
- ***Tabular disclosure***: The compensation committee should provide tabular disclosure of the dollar value payable, including gross-ups and all related taxes payable by the company, to each member of the executive oversight group under each scenario covered by the contracts/agreements/arrangements, including change-in-control, death/disability termination with/without cause and resignation.

- **Timely disclosure:** New executive employment contracts or amendments to existing contracts should be immediately disclosed in 8-K filings and promptly disclosed in subsequent 10-Qs.

Shareowner ratification

Shareowners should ratify all employment contracts, side letters or other agreements providing for severance, change-in-control or other special payments to executives exceeding 2.99 times average annual salary plus annual bonus for the previous three years.

RETIREMENT ARRANGEMENTS

Deferred compensation plans, supplemental executive retirement plans, retirement packages and other retirement arrangements for highly paid executives can result in hidden and excessive benefits. The Council believes that special retirement arrangements, including ones structured to permit employees whose compensation exceeds IRS limits to fully participate in similar plans covering other employees, should be consistent with programs offered to the general workforce, and they should be reasonable.

Structure

- **Supplemental executive retirement plans (SERPs):** Supplemental plans should be an extension of the retirement program covering other employees. They should not include special provisions, such as above-market interest rates and excess service credits, not offered under plans covering other employees. Payments such as stock and stock options, annual/long-term bonuses and other compensation not awarded to other employees and/or not considered in the determination of retirement benefits payable to other employees should not be considered in calculating benefits payable under SERPS.
- **Deferred compensation plans:** Investment alternatives offered under deferred compensation plans for executives should mirror those offered to employees in broad-based deferral plans.

Limitations

- **Deferred compensation plans:** Above-market returns should not be applied to executive deferrals, and executives should not receive “sweeteners” for deferring cash payments into company stock.
- **Post-retirement exercise periods:** Executives should be limited to three-year postretirement exercise periods for stock option grants.
- **Retirement benefits:** Executives should not be entitled to special perquisites—such as apartments, automobiles, use of corporate aircraft, security, financial planning—and other benefits upon retirement. Executives are highly compensated employees who should be more than able to cover the costs of their retirements.

Proxy statement disclosure

- **Transparency:** The terms of any deferred compensation, retirement, SERP or other similar plans covering the executive oversight group should be fully disclosed, in plain English, along with a description of any additional perquisites or benefits payable to executives after retirement.

- **Tabular disclosure:** A single table should be provided detailing the expected dollar value payable to each member of the executive oversight group under any deferred compensation, retirement, SERP or similar plan, along with a dollar value of any additional perquisites of benefits payable after retirement.

STOCK OWNERSHIP

Structure

- **Stock ownership:** Executives and directors should own, after a reasonable period of time, a meaningful position in the company's common stock. Executives should be required to own stock—excluding unexercised options and unvested stock awards—equal to a multiple of salary, scaled based on position, such as two times salary for lower-level executives and up to six times salary for the CEO.

Limitations

- **Stock sales:** Executives should be required to sell stock through pre-announced program sales or by providing a minimum 30-day advance notice of any stock sales.
- **Post-retirement holdings:** Executives should be required to continue to satisfy the minimum stock holding requirements for at least six months after leaving the company.

Proxy statement disclosure

- **Transparency:** Companies should disclose stock ownership requirements and whether any members of the executive oversight group are not in compliance.

VI. Non-Employee Director Compensation

Given the vital importance of the responsibilities assigned to directors, the Council expects that non-employee directors will devote significant time to their boardroom duties.

The Council believes that policy issues related to director compensation are fundamentally different from executive compensation. The Council is supportive of director compensation policies that accomplish the following goals: 1) attract highly qualified candidates; 2) retain highly qualified directors; 3) align directors' interests with those of the long-term owners of the corporation; and, 4) provide complete disclosure to shareowners regarding all components of director compensation including the philosophy behind the program and all forms of compensation.

To accomplish these goals, director compensation should consist solely of a combination of cash retainer and equity-based compensation. The cornerstone of director compensation programs should be alignment of interests through the attainment of significant equity holdings in the company meaningful to each individual director. The Council believes that equity obtained with an individual's own capital provides the best alignment of interests with other shareowners. However, compensation plans can provide supplemental means of obtaining long-term equity holdings through equity compensation, long-term holding requirements and ownership requirements.

The Council believes that companies should have flexibility within certain broad policy parameters to design and implement director compensation plans that suit their unique circumstances. To support this flexibility, investors must have complete and clear

disclosure of both the philosophy behind the compensation plan as well as the actual compensation awarded under the plan. Without full disclosure, it is increasingly difficult to earn investors' confidence and support for compensation plans, including both director and executive plans.

Although non-employee director compensation is generally immaterial to a company's bottom line and small relative to executive pay, the Council believes that director compensation is an important piece of a company's governance. Because director pay is set by the board and has inherent conflicts of interest, care must be taken to ensure there is no appearance of impropriety.

Companies should pay particular attention to managing these conflicts.

ROLE OF THE COMPENSATION COMMITTEE IN DIRECTOR COMPENSATION

The compensation committee (or alternative committee comprised solely of independent directors) is responsible for structuring director pay, subject to approval of all the independent directors, so that it is aligned with the long-term interests of shareowners. The unique fact that directors are setting their own compensation necessitates additional emphasis on the following practices:

Responsibilities

- **Total compensation review:** The compensation committee should understand and value each component of director compensation and annually review total compensation potentially payable to each director.
- **Outside advice:** The Council believes that committees should have the ability to utilize a compensation consultant for assistance on director compensation plans. In cases where the compensation committee does utilize a consultant, it should always retain an independent compensation consultant or any other advisors as deemed appropriate to assist with the evaluation of the structure and value of director compensation. A summary of the pay consultant's advice should be provided in the annual proxy statement in plain English. The compensation committee should disclose all instances where the consultant is also retained (by the committee) to provide advice on executive compensation. In no circumstances should the committee utilize a consultant for director compensation or executive compensation who is also retained by management.

Proxy statement disclosure

- **Tabular disclosure:** Annual proxy statement disclosure should include a table with columns valuing each component of compensation paid to each director during the previous year. The table should also include a column estimating the total value, including the present value of equity awards, of each director's annual pay package and any other relevant information. The table should include the number of board meetings and committee meetings attended by the director.
- **Compensation committee report:** The annual director compensation disclosure included in the proxy materials should include a discussion of the philosophy for director pay and the processes for setting director pay levels. Reasons for changes in director pay programs should be explained in plain English. Peer group(s) used to compare director pay packages should be fully disclosed, along with differences, if any, from the peer

group(s) used for executive pay purposes. While the Council recognizes the value of peer analysis, we do not believe that peer-relative justification should dominate the rationale for (higher) pay levels. Rather, compensation programs should be appropriate for the circumstances of the company. The report should disclose how many committee meetings involved discussions of director pay.

The following sections provide Council policy positions on specific components of director compensation and related issues.

RETAINER

The annual retainer should be the sole form of cash compensation paid to non-employee directors. Ideally, it should reflect an amount appropriate for a director's expected duties, including attending meetings, preparing for meetings/discussions and performing due diligence on sites/operations (which should include routine communications with a broad group of employees.) The Council recognizes that in some combination, the retainer and the equity component combined also reflect the director's contribution from experience and leadership.

The Council opposes meeting attendance fees—whether for board meetings or committee meetings—since meeting attendance is the most basic expectation of a non-employee director.

Retainer amounts may be differentiated to recognize that certain non-employee directors, possibly including independent board chairs, independent lead directors, committee chairs or members of certain committees, are expected to spend more time on board duties than other directors.

The board should have a clearly defined attendance policy. In cases where the committee utilizes any form of financial consequences (loss of a portion of the retainer or equity) as part of the director compensation program, this should be fully disclosed. Financial consequences for poor attendance, while perhaps appropriate in some circumstances, should not be considered in lieu of examining the attendance record, commitment (time spent on director duties) and contribution as integral criterion in director performance and re-nomination decisions.

EQUITY-BASED COMPENSATION

To complement the annual retainer and align director-shareowner interests, non-employee directors shall receive stock awards or stock-related awards such as phantom stock or share units. Equity-based compensation to non-employee directors should be fully vested on the grant date. This point is a marked difference to the Council's policy on executive compensation which calls for performance-based vesting of equity-based awards. While views on this topic have been mixed, the Council believes that the benefits of immediate vesting outweigh the complications. The obvious benefits stem from the immediate alignment of interests with shareowners and the maintenance of independence and objectivity for the director.

The Council believes that equity-based compensation can be an important component of director compensation. These tools are perhaps best suited to accomplish optimal long-term perspective and alignment of interests with shareowners. To accomplish this

objective, the Council believes that director compensation should contain an ownership requirement or incentive and minimum holding period requirements.

The Council suggests ownership requirements of at least three to five times annual compensation. However, the Council is sensitive to situations where qualified director candidates may not have financial means to obtain immediate ownership thresholds. For this reason, companies may adopt unique approaches to providing either a minimum threshold for ownership or incentive to build ownership. This concept should be an integral component of the committee's disclosure related to the philosophy of director pay. It is appropriate to provide a reasonable period of time for directors to meet ownership requirements or guidelines.

Separate from ownership requirements, the Council believes companies should adopt holding requirements for a significant majority of equity-based grants. These policies should require that directors retain a significant portion (such as 80% for example) of equity grants until after they are retired from the board. These policies should also prohibit the use of any transactions or arrangements that mitigate the risk or benefit of ownership to the director. The Council believes that these transactions and arrangements will inhibit the alignment of interests obtained from providing equity compensation and ownership requirements.

The Council does not advocate a specific split between equity-based and cash compensation. Rather, we believe that companies should have the flexibility to set and adjust this ratio as may be appropriate for the circumstances. Accordingly, the rationale behind this decision is an important element of disclosures related to the overall philosophy of director compensation.

Proxy statement disclosure

- **Transparency:** The present value of equity awards paid to each director during the previous year and the philosophy and process used in determining director pay should be fully disclosed in the proxy statement.

Shareowner approval

- Current listing standards require shareowner approval of equity-based compensation plans and material amendments to plans (with limited exceptions). The Council strongly supports this concept and advocates that companies adopt conservative interpretations of approval requirements when confronted with choices. (For example, this may include material amendments to the plan).

PERFORMANCE-BASED COMPENSATION

While the Council is a strong advocate of performance-based concepts in executive compensation, we do not support performance measures in director compensation. Performance-based compensation for directors has significant potential to conflict with the director's primary role as an independent representative of shareowners.

PERQUISITES

Aside from meeting-related expenses such as air-fare, hotel accommodations and modest travel/accident insurance, the Council believes that directors should receive no other perquisites. Health, life and other forms of insurance, matching grants to charities,

financial planning, automobile allowances and other similar perquisites cross the line as benefits offered to employees. The Council believes that charitable awards programs are an unnecessary benefit; directors interested in posthumous donations can do so on their own via estate planning.

Infrequent token gifts of modest value are not considered perquisites.

REPRICING AND EXCHANGE PROGRAMS

The Council believes that under no circumstances should directors participate in or be eligible for repricing or exchange programs.

EMPLOYMENT CONTRACTS, SEVERANCE AND CHANGE-OF-CONTROL PAYMENTS

Non-employee directors should not be eligible to receive any change-in-control payments or severance arrangements of any kind.

RETIREMENT ARRANGEMENTS

Since non-employee directors are elected representatives of shareowners and not company employees, they should not be offered retirement benefits such as defined benefit plans or deferred stock awards nor should they be entitled to special post-retirement perquisites.

The Council does not object to allowing directors to defer cash pay via a deferred compensation plan for directors. However, the Council believes that such investment alternatives offered under deferred compensation plans for directors should mirror those offered to employees in broad-based deferral plans. Non-employee directors should not receive “sweeteners” for deferring cash payments into company stock.

DISGORGEMENT

Directors should be required to repay compensation to the company in the event of malfeasance or a breach of fiduciary duty involving the director.

VII. Independent Director Definition

Members of the Council of Institutional Investors believe that the promulgation of a narrowly drawn definition of an independent director (coupled with a policy specifying that at least two-thirds of board members and all members of the audit, compensation and nominating committees should meet this standard) is in the corporation's and all shareowners' ongoing financial interest because:

independence is critical to a properly functioning board,

certain clearly definable relationships pose a threat to a director's unqualified independence in a sufficient number of cases that they warrant advance identification,

the effect of a conflict of interest on an individual director is likely to be almost impossible to detect, either by shareowners or other board members, and,

while an across-the-board application of *any* definition to a large number of people will inevitably miscategorize a few of them, this risk is sufficiently small that it is far outweighed by the significant benefits.

Thus, the members of the Council approved the following basic definition of an independent director:

an independent director is someone whose only nontrivial professional, familial or financial connection to the corporation, its chairman, CEO or any other executive officer is his or her directorship.

Stated most simply, an independent director is a person whose directorship constitutes his or her only connection to the corporation.

The members of the Council recognize that independent directors do not invariably share a single set of qualities that are not shared by non-independent directors. Consequently no clear rule can unerringly describe and distinguish independent directors. However, the independence of the director depends on all relationships the director has, including relationships between directors, that may compromise the director's objectivity and loyalty to shareowners. It is the obligation of the directors to consider all relevant facts and circumstances, to determine whether a director is to be considered independent. The notes that follow are supplied to give added clarity and guidance in interpreting the specified relationships.

A director will not be considered independent if he or she:

(a) is, or in the past 5 years has been, or whose relative is, or in the past 5 years has been, employed by the corporation or employed by or a director of an affiliate; An "affiliate" relationship is established if one entity either alone or pursuant to an arrangement with one or more other persons, owns or has the power to vote more than 20 percent of the equity interest in another, unless some other person, either alone or pursuant to an arrangement with one or more other persons, owns or has the power to vote a greater percentage of the equity interest. For these purposes, joint venture partners and general partners meet the definition of an affiliate, and officers and employees of joint venture enterprises and general partners are considered affiliated. A subsidiary is an affiliate if it is at least 20 percent owned by the corporation.

Affiliates include predecessor companies. A "predecessor" is an entity that within the last 5 years was party to a "merger of equals" with the corporation or represented more than 50 percent of the corporation's sales or assets when such predecessor became part of the corporation.

"Relatives" include spouses, parents, children, step-children, siblings, mothers and fathers-in-law, sons and daughters-in-law, brothers and sisters-in-law, aunts, uncles, nieces, nephews and first cousins, and anyone sharing the director's home.

(b) is, or in the past 5 years has been, or whose relative is, or in the past 5 years has been, an employee, director or **greater-than-20-percent** owner of a firm that is one of the corporation's or its affiliate's paid advisers or consultants or that receives revenue of at least \$50,000 for being a paid adviser or consultant to an executive officer of the corporation;

NOTES: Advisers or consultants include, but are not limited to, law firms, auditors, accountants, insurance companies and commercial/investment banks. For purposes of this definition, an individual serving “of counsel” to a firm will be considered an employee of that firm.

The term "executive officer" includes the chief executive, operating, financial, legal and accounting officers of a company. This includes the president, treasurer, secretary, controller and any vice-president who is in charge of a principal business unit, division or function (such as sales, administration or finance) or performs a major policymaking function for the corporation.

(c) is, or in the past 5 years has been, or whose relative is, or in the past 5 years has been, employed by or has had a 5 percent or greater ownership interest in a third-party that provides payments to or receives payments from the corporation **and either (i) such payments account for 1 percent of the third-party's or 1 percent of the corporation's consolidated gross revenues in any single fiscal year, or (ii) if the third-party is a debtor or creditor of the corporation and the amount owed exceeds 1 percent of the corporation's or third party's assets.** Ownership means beneficial or record ownership, not custodial ownership.

(d) has, or in the past 5 years has had, or whose relative has paid or received more than \$50,000 in the past 5 years under, a personal contract with the corporation, an executive officer or any affiliate of the corporation;

NOTES: Council members believe that even small personal contracts, no matter how formulated, can threaten a director's complete independence. This includes any arrangement under which the director borrows or lends money to the corporation at rates better (for the director) than those available to normal customers -- even if no other services from the director are specified in connection with this relationship.

(e) is, or in the past 5 years has been, or whose relative is, or in the past 5 years has been, an employee or director of a foundation, university or other non-profit organization that receives significant grants or endowments from the corporation, one of its affiliates or its executive officers or has been a *direct* beneficiary of *any* donations to such an organization;

NOTES: A “significant grant or endowment” is the lesser of \$100,000 or 1 percent of total annual donations received by the organization.

(f) is, or in the past 5 years has been, or whose relative is, or in the past 5 years has been, part of an interlocking directorate in which the CEO or other employee of the corporation serves on the board of a third-party entity (for-profit or not-for-profit) employing the director **or such relative**;

(g) has a relative who is, or in the past 5 years has been, an employee, a director or a 5 percent or greater owner of a third-party entity that is a significant competitor of the corporation; or

(h) is a party to a voting trust, agreement or proxy giving his/her decision making power as a director to management except to the extent there is a fully disclosed and narrow voting arrangement such as those which are customary between venture capitalists and management regarding the venture capitalists' board seats.

The foregoing describes relationships between directors and the corporation. The Council also believes that it is important to discuss relationships between directors on the same board which may threaten either director's independence. A director's objectivity as to the best interests of the shareowners is of utmost importance and connections between directors outside the corporation may threaten such objectivity and promote inappropriate voting blocks. As a result, directors must evaluate all of their relationships with each other to determine whether the director is deemed independent. The board of directors shall investigate and evaluate such relationships using the care, skill, prudence, and diligence that a prudent person acting in a like capacity would use.

(updated March 20, 2007).



**Testimony of
Jeffrey P. Mahoney
General Counsel
Council of Institutional Investors
before the
Permanent Subcommittee on Investigations
of the
Committee on Homeland Security and Governmental Affairs
June 5, 2007**

Attachment 3

Council Board of Directors

Council Board of Directors

Council Officers

Jack Ehnes
Board Chair

▶ [California State Teachers' Retirement System](#)

Bruce Raynor
Co-Chair

▶ [UNITE HERE National Retirement Fund](#)

Gail Stone
Treasurer

▶ [Arkansas Public Employees' Retirement System](#)

Ann Yerger
Executive Director (*non-board member*)

▶ [Council of Institutional Investors](#)

Board Members

Mary Collins

▶ [The District of Columbia Retirement Board](#)

Benny Hernandez

▶ [Sheet Metal Workers' National Pension Fund](#)

▶ **D. Craig Nordlund**
[Agilent Technologies Benefit Plans](#)

Jody Olson

▶ [Idaho Public Employees Retirement System](#)

Meredith Williams

▶ [Public Employees' Retirement Association of Colorado](#)

Peggy Foran
Co-Chair

▶ [Pfizer Retirement Annuity Plan](#)

Kathy-Ann Reissman
Co-Chair

▶ [Employees Retirement System of Texas](#)

Warren Mart
Secretary

▶ [I.A.M. National Pension Fund](#)

Peter Gilbert

▶ [Pennsylvania State Employees' Retirement System](#)

Richard Metcalf

▶ [Staff Pension Plan of LIUNA](#)

Joe Dear

▶ Washington Statement Investment Board

Dennis Johnson

▶ [California Public Employees' Retirement System](#)



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Attachment 4

Council Correspondence Referenced in Full Text of Statement

Council Correspondence Referenced in Full Text of Statement

1. Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to The Honorable Barney Frank, House of Representatives (Apr. 5, 2007).
2. Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Conrad Hewitt, Chief Accountant, Securities and Exchange Commission (Apr. 2, 2007) (including attachment Compensation Valuation, Inc., Zions Bancorporation ESOARS: An Evaluation, Mar. 30, 2007).
3. Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Conrad Hewitt, Chief Accountant, Securities and Exchange Commission (Feb. 5, 2007).
4. Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to Nancy M. Morris, Secretary, Securities and Exchange Commission (Jan. 25, 2007).
5. Letter from Jeff Mahoney, General Counsel, Council of Institutional Investors to The Honorable Richard C. Shelby, Committee on Banking, Housing, and Urban Affairs, United States Senate (Sept. 8, 2006).
6. Letter from Ann Yerger, Executive Director, Council of Institutional Investors to Nancy M. Morris, Secretary, Securities and Exchange Commission (June 21, 2006).
7. Letter from Ann Yerger, Executive Director, Council of Institutional Investors to Nancy M. Morris, Secretary, Securities and Exchange Commission (Mar. 29, 2006) (including Appendix I).

COUNCIL OF INSTITUTIONAL INVESTORS

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Via Hand Delivery

April 5, 2007

The Honorable Barney Frank
House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

On behalf of the members, board of directors, and staff of the Council of Institutional Investors (“Council”), I am writing to congratulate you on the Committee on Financial Services (“Committee”) successful mark-up of H.R. 1257, the “Shareholder Vote on Executive Compensation Act.”

The Council is an association of more than 135 corporate, public and union pension funds with more than \$3 trillion in pension assets. Council members are responsible for investing and safeguarding assets used to fund pension benefits of millions of participants and beneficiaries throughout the United States (“US”). Since the average member invests approximately 75 percent of its entire pension portfolio in US stocks and bonds, issues relating to US corporate governance and the Committee’s critical oversight role with respect to those issues are of great interest to our members.

The Council believes that executive compensation is a critical and visible aspect of a company’s governance. Pay decisions are one of the most direct ways for shareowners to assess the performance of the board.

On March 20, 2007, the Council’s general members unanimously approved the following revision to the Council’s corporate governance policies:

Companies should provide annually for advisory
shareowner votes on the compensation of senior executives.

In approving this policy, Council members generally agreed that an annual shareowner vote on executive compensation would benefit investors and the capital markets for a number of reasons.

Provides a mechanism for ongoing input on compensation

First, while investors have grown more concerned about perceived excesses and abuses of executive pay at US public companies, they have limited ability to signal their disapproval to boards or to shape pay policies. A December 2006 study by *The*

Corporate Library found that the median total compensation for some 1,700 chief executive officers (“CEO”) nearly tripled from fiscal 1999 to 2005. Ninety percent of institutional investors think US executives are overpaid, according to a 2005 *Watson Wyatt* survey of 55 institutions managing a total of \$800 billion in assets.

While non-binding votes on executive pay practices are required in Australia, Sweden and the United Kingdom (“UK”), shareowners of US companies currently have no way to directly vote on all compensation matters. US stock exchanges mandate shareowner approval of equity-based compensation plans and investors must endorse performance criteria before companies can deduct compensation exceeding \$1 million, but compensation committees have substantial leeway in setting yearly performance targets and granting awards. Investors at US companies currently do not have a mechanism to provide ongoing input on how a company’s general compensation policies are applied to individual pay packages.

Provides a less blunt instrument than withholding support from directors

Second, shareowners can and do withhold support from compensation committee members standing for re-election, but withhold campaigns can be a blunt instrument for registering dissatisfaction with the committee’s administration of pay plans and policies. The tactic can threaten the position of directors “who may very well have argued against the issue which causes shareholder concern, and often puts management in the position of having to defend individual directors,” says Bess Joffe, manager for the Americas at *Hermes Equity Ownership Services*. She added, “[t]hese situations tend to escalate and become quite personal, ultimately distracting from the issue at hand.”

Non-binding shareowner votes on executive pay might deter votes against directors since shareowners would have a “more specific and accurate place on the proxy to communicate concerns over pay,” says Elizabeth McGeeveran, vice president for governance and socially responsible investment at *F&C Asset Management* (“F&C”). Of course, if a compensation committee failed to respond to an advisory vote that showed significant shareowner disapproval of pay practices, “investors might vote against committee members the following year,” says Daniel Summerfield, investment adviser to the *Universities Superannuation Scheme*, one of the UK’s largest pension funds.

Positive results in the UK

Finally, UK regulations requiring advisory shareowner votes on executive compensation went into effect in 2002, and have resulted in “better disclosure, better and more dialogue between shareholders and companies, and more thought put into remuneration policy by directors,” according to David Paterson, research director of UK-based *Research, Recommendations and Electronic Voting*, a proxy advisory service. British drugmaker *GlaxoSmithKline* (“GSK”) is a case-in-point. In 2003, 51 percent of GSK shareowners protested the CEO’s golden parachute package by either voting against or abstaining from voting on the company’s remuneration report. Stunned, the GSK board held talks with shareowners and the next year reduced the length of executive contracts and set new

performance targets, muting investor criticism. Other UK companies got the message and now routinely seek investor input on compensation policies.

There is no guarantee that all the benefits attained from advisory shareowner votes on executive pay in the UK would be realized in the US. Stock ownership is far more concentrated in the UK, and British institutional investors have a strong tradition of standing up to company management and boards. As a result, UK boards are more inclined to take investor concerns about pay seriously. Even so, advisory shareowner votes—by their very nature—would benefit investors in US companies by providing a clear and direct way to communicate their views on executive compensation. “Voting results could also give directors leverage to resist executives’ demands for lavish rewards,” adds McGeeveran of F&C.

In summary, the Council believes that an annual shareowner advisory vote on executive compensation would efficiently and effectively provide boards with useful information about whether investors view the company’s compensation practices to be in shareowners’ best interests. Nonbinding shareowner votes on pay would serve as a direct referendum on the decisions of the compensation committee, and would offer a more targeted way to signal shareowner discontent than withholding votes from committee members.

Thank you again for your leadership and efforts to improve corporate governance practices. We look forward to continuing to work closely with you and your staff to ensure that the US capital market system continues to serve the needs of investors.

Sincerely,



Jeff Mahoney
General Counsel

cc: The Honorable Spencer Bachus, Ranking Member, Committee on Financial Services
The Honorable Paul E. Kanjorski, Chairman, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
The Honorable Deborah D. Pryce, Ranking Member, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises
The Honorable Christopher J. Dodd, Chairman, Committee on Banking, Housing, and Urban Affairs
The Honorable Richard C. Shelby, Ranking Member, Committee on Banking, Housing, and Urban Affairs
The Honorable Jack Reed, Chairman, Subcommittee on Securities, Insurance, and Investment
The Honorable Wayne Allard, Ranking Member, Subcommittee on Securities, Insurance, and Investment

COUNCIL OF INSTITUTIONAL INVESTORS

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Via Hand Delivery

April 2, 2007

Conrad Hewitt
Chief Accountant
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Zions Bancorporation ESOARS

Dear Mr. Hewitt:

I am writing on behalf of the Council of Institutional Investors, an association of more than 135 public, corporate and union pension funds with combined assets of over \$3 trillion (“Council”). This letter is a follow-up to our letter to you of February 5, 2007,¹ regarding your office’s approval of Zions Bancorporation’s (“Zions”) Employee Stock Option Appreciation Rights Securities (“ESOARS”) for use as a market-based approach for valuing employee share-based payment awards under Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* (“Statement 123R”).² We very much appreciate your February 23, 2007, letter in response to our February 5th letter, and the related telephone call by Joe Ucuzoglu of your office.³

As indicated in our February 5th letter, the Council has been, and continues to be, a strong proponent of Statement 123R.⁴ We believe Statement 123R improves financial accounting and reporting of share-based payment awards by requiring that, consistent with the Council’s corporate governance policies, all employee share-based payment awards be accounted for as compensation costs appropriately reducing reported earnings.⁵ We also are a strong proponent of the fair value measurement objective and related implementation guidance contained in Statement 123R.⁶ We agree, as stated in that guidance, that “[o]bservable market prices of identical or similar equity or liability

¹ Letter from Jeff Mahoney, General Counsel, *Council of Institutional Investors*, to Conrad Hewitt, Chief Accountant, *Securities and Exchange Commission* (Feb. 5, 2007).

² Letter from Conrad Hewitt, Chief Accountant, *Securities and Exchange Commission*, to Mr. James G. Livingston, Vice President, *Zions Bancorporation 1* (Jan. 25, 2007) (“Based on our review of your Submissions, and subject to your adoption of the modifications recommended in the following paragraph, the SEC staff concurs with your view that the ESOARS instrument is sufficiently designed to be used as a market-based approach to valuing employee share-based payment awards under Statement 123R.”).

³ Letter from Conrad Hewitt, Chief Accountant, *Securities and Exchange Commission*, to Jeff Mahoney, General Counsel, *Council of Institutional Investors* (Feb. 23, 2007).

⁴ Letter from Jeff Mahoney, *supra* note 1, at 1 n.3.

⁵ *Id.* at 1 n.4.

⁶ *Id.* at 1.

instruments in active markets are the best evidence of fair value and, if available, should be used as the basis for the measurement of equity and liability instruments awarded in a share-based payment transaction with employees.”⁷

As also indicated in our February 5th letter, and in my telephone conversation with Mr. Ucuzoglu, the Council would “. . . (1) carefully analyze Zions’ ESOARS, (2) consult with leading valuation and accounting experts, and (3) report to your office any concerns about whether the approach produces sufficiently reliable values for financial reporting purposes.”⁸ Since February 5th I have had numerous informal conversations with many leading valuation and accounting experts to obtain their views on Zions’ ESOARS. In addition, the Council retained Compensation Valuation Inc. (“CVI”), a firm specializing in the valuation of employee stock options, to perform an evaluation of Zions’ ESOARS.

CVI’s report containing its assessment and recommended remedies regarding the “suitability of the ESOARS product for purposes of financial disclosure under FAS 123R” is attached to this letter for your review (“CVI Report”).⁹ In summary, consistent with the views of other leading valuation and accounting experts, the CVI Report concludes:

. . . the ESOARS product is too flawed to serve as a reliable valuation tool for FAS 123R purposes. While the tracking security itself is imperfect but not unreasonable, in combination with the auction mechanism and surrounding conditions and incentives, the design serves primarily to produce a predictably downward biased result.¹⁰

The CVI Report offers several “major modifications” designed to remedy the defects with Zions’ ESOARS including: (1) significantly increasing the issuance size and eliminating the artificial restrictions on bidders and holders of Zions’ ESOARS, and (2) reversing the Zions’ ESOARS so that Zions (and other companies valuing their employee stock options) must purchase (rather than sell) the ESOARS from third party suppliers.¹¹ The CVI Report notes that

. . . [w]ithout remedies or alternatives such as those proposed above, the ESOARS price should not be accepted by auditors nor certified by senior executives as correctly measuring the cost of a company’s ESOs.¹²

⁷ Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, ¶ A7 (footnote omitted).

⁸ Letter from Jeff Mahoney, *supra* note 1, at 2.

⁹ Compensation Valuation Inc., *Zions Bancorp ESOARS: An Evaluation 1* (March 30, 2007).

¹⁰ *Id.* at 6; *see also* William Ortner et al., *Equity Compensation and the Capital Markets*, Citigroup Corporate and Investment Banking 19 (Aug. 15, 2006) (Zions’ ESOARS result . . . “in the ‘market’ bid for the instrument certainly being a lowball one.”).

¹¹ Compensation Valuation, Inc., *supra* note 9, at 6-8.

¹² *Id.* at 8.

As indicated in our February 5th letter, it is our understanding that Zions plans to hold an auction for ESOARS within the next few weeks for purposes of valuing their own employee stock options for financial accounting and reporting.¹³ It is also our understanding that Zions plans to “handle” ESOARS auctions for a number of clients in the coming months and that those companies will use the auctions to value and report the fair value of their own employee stock options.¹⁴

Given the findings of the CVI Report and the results of my conversations with other leading valuation and accounting experts, we are deeply concerned that Zions’ ESOARS will result in information reported to investors that will not faithfully reflect the true costs of an enterprise’s employee share-based awards. Investors have long been misled about the costs of employee share-based compensation, as evidenced most recently in connection with the far too common practice of stock option backdating.

Given the magnitude of employee share-based compensation (over \$40 billion for the S&P 500),¹⁵ and its continued prevalent use, investors cannot afford to continue to be given purposely biased information about the costs of these awards. We, therefore, would respectfully request that your office prohibit Zions and all other public companies from using the Zions’ ESOARS product to value employee share-based payment awards for financial accounting and reporting purposes unless and until the fundamental failings of the product have been remedied.

We look forward to meeting with you and other SEC staff in the near future to discuss this letter and the CVI Report in more detail. In the meantime, please contact me with any questions or if you need any additional information.

Sincerely,



Jeff Mahoney
General Counsel

Attachment

CC: Chairman Christopher Cox
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Kathleen L. Casey
Commissioner Annette L. Nazareth
Chester Spatt, Chief Economist, Office of Economic Analysis

¹³ David Reilly and Serena Ng, *SEC Clears Market-Based Way To Value Staff Stock Options*, Wall St. J., Jan. 30, 2007, at C5.

¹⁴ *SEC approves Zions’ stock-option valuation system*, Salt Lake Trib., Jan. 31, 2007, at 1.

¹⁵ Jack T. Ciesielski, *A Sputtering Love Affair: Stock Options of the S&P 500, 2005*, 15 Analyst’s Acct. Observer 1 (May 2, 2006).

John W. White, Director, Division of Corporation Finance

Zions Bancorporation ESOARS: An Evaluation

by

Compensation Valuation, Inc. (CVI)

30 March 2007

This report was prepared by Stephen A. Ross with the assistance of Rick Antle, Greta Hotopp, Andrew Jeffrey, and Richard Roll, principals of CVI, at the request of the Council of Institutional Investors. CVI is a company specializing in the valuation of employee stock options. Brief bios of the principals are appended at the end of the report. CVI has never had a business relation with Zions Bancorporation.

Assignment

Zions Bancorporation (Zions) has developed a product, ESOARS, which is intended to help determine the value of employee stock options (ESOs) for purposes of financial disclosure under FAS 123R. The Council of Institutional Investors (CII) has solicited my opinion and that of CVI on the suitability of the ESOARS product for purposes of FAS 123R.

The ESOARS Security

The ESOARS security is designed to track the payoffs of a company's ESOs.¹⁶ It will be sold in a public auction to fix its value and, by inference, the value of the associated ESOs.¹⁷ The ESOARS security is a tracking instrument that pays the holder a constant fraction of the actual payouts made by the company to its employees as they exercise their options. To adjust for pre-vesting forfeitures, security holders will be reimbursed for their original bid, with interest, on a pro rata basis.¹⁸ In the event of a modification of the terms of the ESOs, e.g., an altered strike price, Zions has the right to cancel the security at a price to be determined by a third party.¹⁹ The cancellation procedure is not well described, although a model-based valuation is mentioned.

Possible cancellation introduces an element of uncertainty that can potentially lead to a significant divergence between the value of the ESOARS security and the value of a perfect tracking instrument not subject to cancellation at modification. With this exception, though, a correct value for the ESOARS security would serve as a benchmark for the cost to the company of issuing ESOs.

We turn now to the proposed auction mechanism for valuing ESOARS.

The ESOARS Auction

The ESOARS auction is meant to mimic the Treasury auction.²⁰ Participants submit bids for the tracking security consisting of the amount they wish to acquire at specified prices. These offer prices are arrayed from highest to lowest in a simulated demand curve for the security. The actual sale price is determined as the highest price such that the aggregate

¹⁶ "Zions Bancorporation ESOARS, Summary prepared for: Office of the Chief Accountant, Securities and Exchange Commission" at: https://www.esoarsauction.com/pma/faq/zions_submission.pdf ("Summary"), page 6.

¹⁷ Summary, p.2.

¹⁸ "ESOARS holders will be reimbursed, with interest, for the pro rata share of the amount paid for the ESOARS securities for employee stock options in the reference pool that are forfeited prior to vesting," <https://www.esoarsauction.com/pma/faq/#is5>. This was not the case for the 2006 auction.

¹⁹ Summary, p. 8.

²⁰ References to the U.S. Treasury are made in relation to the choice of format ("Modified Dutch auction" section, p. 12), resolutions of tie bids ("Tie bids at stop price" section, p. 13), and limitations on bids ("Maximum bid amounts" section, p. 15), and elsewhere, Summary, pages 12, 13, and 15.

of the offers at and above that price just consumes the supply. If total demand at the sale price exceeds supply, then the highest offers are satisfied first while those who bid exactly the sale price are allocated securities in proportion to the amount they offered to buy (although subject to restrictions as described below).

ESOARS For Purposes of FAS 123R

The value of any asset or security is most reliably determined by its price in a well-functioning liquid market that attracts adequate interest from investors. Such a market has low transactions costs and is able to absorb a large volume of trade with minimal price impact. A consistently small bid/ask spread is a typical attribute of such a liquid market.

The security being traded must have adequate public information for market participants to form a reasoned opinion of value, and the security must be supplied in a quantity sufficient to warrant the attention of investors and speculators and cover the cost of information processing relative to asset value. Participants in the market for complex securities typically rely on models to determine their own assessments of value, but the market price aggregates disparate views and is the best representation of value. Because of these features, a liquid market is said to lead to price discovery.

Similar conditions apply to auctions. To produce a good estimate for the value of the security being sold, the auction must have low barriers to entry so that it can attract the interest of many informed and well-capitalized buyers. Ideally, it should attract institutional buyers who have the capacity to model the product, particularly for a security with ESOARS's complexity. An auction is one-sided in that potential bidders decide whether or not to participate and, if so, to what extent; when an auction attracts many bidders with sufficient resources, competition prevents the sale price from undervaluing the security. On the other hand, when bidding is restricted and competitive forces are weakened, one can expect undervaluation.

Unfortunately, the ESOARS auction is not likely to fulfill the conditions to permit true price discovery. Difficulties arise from restrictions placed on participants in the ESOARS auction, from the small size being offered and from incentives of the seller. Further dampening conditions include a contingency to eliminate competitive bidding, delays in payments to security holders, mandatory account-holding by winning bidders post-auction with Zions' brokerage arm (Zions Direct) and pre-auction consideration of each bidder's Zions Direct balance, which affects the maximum bid allowed. In addition, bidders are faced with the prospect of an unsupported secondary market and undefined third-party valuations affecting the virtual "callability" of the security upon ESO modification.

Not surprisingly, these factors preclude the ESOARS auction mechanism from satisfying the basic requirements for liquidity and price discovery and make it highly likely that the ESOARS auction price will significantly understate the true cost of ESOs to the firm.

We will now explain in more detail how various auction features impact the resulting sale price.

Bidder Cost/Benefit

The small size of the offering (actual proceeds in Zions' June auction were only \$702,075 and the restricted maximum bid was just \$350,000²¹) makes the security unsuitable for large or institutional holders. The additional requirement that any winning bidder become (if not already one at the time of the auction) a customer of Zions Direct would be a further barrier for some investors. It is particularly ominous that Zions takes into account the size of the customer's deposit in determining the maximum allowable bid. The suggestion that bidders who are pre-auction customers of Zions Direct may be allowed a larger bid is a serious barrier to institutional involvement.

The diminutive size of the issue has other predictable effects. In their summary to the Office of the Chief Accountant of the SEC, Zions reported that there were 82 registered bidders, 57 of whom actually made bids. They note that there were 5 institutions amongst the 82 registered bidders, although they do not identify how many of those actually submitted bids.²² The small scale makes it uneconomic for an investor to exert significant effort in studying the offering. At CVI, we were approached by a hedge fund seeking a valuation, but, upon learning of the restrictions and the size of the ESOARS offering, they decided not to participate. To the extent that this is a typical reaction, the bidders who did participate would be far from a representative sample of investors.

Perhaps the closest market that currently exists to securities such as the ESOARS is the market for individual company stock options. The average trading volume in Zions options, for example, is approximately 300 per day,²³ i.e., options on 30,000 individual shares. By contrast, the Zions auction was for 93,610 units. To put this in perspective, the auction represented around the same number of underlying shares as the average number of Zions options traded in the listed market over a three-day period. It is important to realize that listed options are by comparison much simpler instruments than the ESOARS security and that investors can hedge them with positions in the underlying stock (and vice versa). Moreover, they are traded in two-sided, low cost, liquid secondary markets supported by multiple market-makers.

By contrast, the ESOARS instrument is sui generis, less convenient to hedge or to use as a hedge, not tradable in an efficient two-sided aftermarket, and not a simple substitute for holding the stock itself. Unlike a warrant issued by a company or a private placement, information about the issuing company is a smaller component of the ESOARS' value; instead, they are more subject to the proclivities of Zions employees.

²¹ Summary, p. 15.

²² The reported number of bidders, number of institutions, and number who made bids, Summary, p. 15.

²³ Calculated from The Options Clearing Corporation's online Volume Query results, data for the period 26 March 2006 through 26 March 2007, divided by two to represent one contract side, and divided by 252 to represent an average daily volume of over 296 over the one-year period, http://www.optionsclearing.com/market/volume/volbyproduct_form.jsp as accessed on 26 March 2007.

FAS 123R requires that the ESO valuation represents the actual cost to the company of its employee option grant payouts. But if the limited market supply results in a low ESOARS value, this has nothing to do with actual ESO costs. It does indicate that the auction is not sufficiently well functioning to enable price discovery.

Lack of a Supported Secondary Market

The lack of commitment to a secondary market further diminishes the potential for a reliable valuation in the initial auction, and removes a check on the validity of price discovery. All investors are reluctant to take on a position that can only be unwound at significant discount from inherent value. ESOARS are in this aspect analogous to unregistered stock, which invariably sells at a discount. Subsequent illiquidity in the ESOARS secondary market renders the purchase a ‘buy-and-hold’ decision --an unattractive feature at any size.

Zions states that there are no restrictions on the transfer or sale of the ESOARS and that there may not be an active secondary market for ESOARS.²⁴ While it states its intention to facilitate an aftermarket in ESOARS, it will do so only on a best-efforts basis attempting to cross trades between holders who wish to sell and investors who wish to buy, and for large holders, it will run an auction if they wish.²⁵ This is a far cry from what is needed: a market-maker who stands continually ready to buy and sell within a limited spread.

Without an adequate secondary market, for this diminutive auction there is no objective market-based way to judge whether the initial sale price really is a fair estimate of the cost of issuing the ESOs, rather than a one-time, limited-size sacrificial sale meant to create the façade of a market for reporting purposes. The failure of Zions to support a market in the security after the auction is consistent with this interpretation; typically when companies issue warrants they promise to make a secondary market in them to increase their attractiveness to investors. If Zions truly believed that the auction produced the right price, then they would be willing to stand as or enlist a market-maker in the security and sell or purchase large amounts with a modest bid-ask spread. Alternatively, Zions should seek offers in the market, rather than bids as we will describe below.

Buyers’ and Seller’s Incentives

Some of the ideas expressed in the press, which at first seem only peripherally related to ESOARS effectiveness in price-discovery, come into play in discussion of the instrument. These press stories, including several which Zions chose to file with the SEC, have made much of comments surrounding Zions’ motives behind their own issuance and their further intention to derive fees from advising other companies who wish to follow suit. According to some reports, interest in the product is expected to hinge on achievement of a lowered expense. Without delving into the accuracy of the

²⁴ “There may not be an active secondary market for ESOARS; therefore, holders may not be able to find a buyer for their securities or may sell them at a loss,” <https://www.esoarsauction.com/pma/faq/#is5>, 25 March 2007.

²⁵ Summary, p. 8.

various stories, as we have shown, the ESOARS's auction does result in a lowered reporting expense for FAS123R.

In a typical auction, the buyer obviously prefers a low price while the seller prefers the opposite. A seller striving to minimize the sales price is atypical in the investment world. However, in the ESOARS auction, both seller and buyer appear to desire the same thing, a low price. Avid competitive bidding amongst the buyers is attenuated for the many reasons we have discussed. In such a situation the price will be artificially low.

But regardless of buyer demand, a lower limit is usually determined by the seller's estimate of true value; after all, the seller can withdraw the security rather than sell it at a ridiculously low price. In a standard auction, the seller often establishes a "reservation" price, the lower limit and point of withdrawal. In the ESOARS case, though, the seller like the buyer has an incentive for the price to be low in order to book a low expense for ESOs, and no such lower limit is set. Zions has an incentive to obtain a low valuation for their ESOARS product, and the small size and one-time nature of the issue allows this incentive to take precedence over the desire to maximize the funds raised by the issue's sale, the normal consideration when issuing a security for the purpose of raising capital.

The extent of the downward bias of ESOARS

How downward-biased is the auction price? It is possible to examine the implications of the price in terms of Zions' own disclosures. Use of the Black-Scholes model in this context does not rely on the Black-Scholes model being correct; it only uses the model to translate price into estimates of the inputs that are more readily compared across different securities.

The reported ESOARS auction price was \$7.50.²⁶ One natural question is what implied volatility would result from this valuation. (In options markets, prices are often thought of in terms of the implied volatility of the option, which traders use as a surrogate by which to compare prices. The implied volatility is the volatility input into the option pricing model so that the resulting price equals the prevailing market price.) Similarly, we could ask what term or expected life would be consistent with the auction price holding other inputs constant.

From Zions' SEC submission,²⁷ the expected life of their options was 4 years, the annual dividend yield was 2% and the interest rate was about 5%. They used a volatility of 18% per year which is close to both the historical volatility and the current implied volatility in the market. Using the Black-Scholes model, the life of the option on grant date would have to be set at about 2.2 years to recover the auction value of \$7.50, or equivalently, a grant-date value of \$8.57²⁸ for FAS123R purposes. This is about half of what Zions estimated to be the expected life and it implies that the ESOs which vest 1/3 in each of

²⁶ June 29, 2006 test auction of ESOARS, <https://www.esoarsauction.com/pma/faq/#is5>, the results of which were used to determine grant-date value of \$8.57 per ESO.

²⁷ Summary, p. 17.

²⁸ Summary, p. 17.

the three years after the grant date would have to be exercised immediately upon vesting. Alternatively, holding other parameters constant, the implied volatility which recovers the auction price is about 10% per year. To put this in perspective, on the auction date, 29 June 2006, only one company in the S&P500 had a volatility lower than 10%.²⁹ Furthermore, the volatility of the S&P 500 Index itself was over 13%.³⁰

In their submission to the Chief Accountant of the SEC, Zions said that “Given the well-publicized criticisms of the Black-Scholes-Merton model, we expected the market value to be somewhat lower than the modeled price and generally are pleased with the pricing obtained in our first-ever ESOARS auction. Over time, the market for ESOARS should grow more efficient.”³¹ The Black-Scholes-Merton model and lattice models certainly have their failings, but exactly what the deficiencies are that would lead these valuation models to be persistently biased above the appropriate value is not clear. What then, is there about the pricing that Zions finds so pleasing? And what could possibly justify implied assumptions for expected life in the model that are bizarre compared to actual exercise behavior or for a volatility so extreme compared to other stocks? Zions is correct that the market should grow more efficient over time, but it won’t happen without creating the conditions for an actual market to develop, instead of a stunted demand curve artificially met by a single, one-time supplier.

In conclusion, the ESOARS product is too flawed to serve as a reliable valuation tool for FAS 123R purposes. While the tracking security itself is imperfect but not unreasonable, in combination with the auction mechanism and surrounding conditions and incentives, the design serves primarily to produce a predictably downward biased result.

Remedies

1. Increase Issuance and Remove Entry Barriers

One way to remedy the failings of the ESOARS’s mechanism and to achieve the goal of market-based valuation for ESOs would be to significantly increase the issuance size, to provide a regular calendar for issuance, and to eliminate the artificial restrictions on bidders and holders of the security. These actions would attract the interest of bidders and put them in a competitive environment where they would be subject to adequate market discipline. An additional benefit of increased size is that it changes the issuer’s incentives to the benefit of market efficiency. As the ESOARS auction is currently designed, the issuer has an incentive to achieve a low price because of perceived benefits associated with the reduction of accounting expense. An economically meaningful issue

²⁹ This information is obtained from Ivolatility.com, a provider of implied volatility data and analyses. In particular Ivolatility.com’s calculations of 180-day call implied volatility on June 29, 2006 for the 496 component companies that were available for computational purposes and the S&P Index itself were used. The one component stock that traded at lower than a 10% implied volatility was in the process of being taken over. ZION was actually the 79th lowest implied volatility in Ivolatility.com’s calculations with a 19.24% implied volatility on that day, from the market data.

³⁰ Of the five component stocks that actually traded at lower implied volatilities than the S&P Index itself on that date, only one was not in the process of being taken over or merged.

³¹ Summary, p. 18.

size would turn the issuer's attention to raising funds at an attractive price, and, as a further consequence, artificial restrictions on bidders hold much less appeal to that issuer.

Zions does have the capacity to make much larger-scale offerings. As examples of the size of Zions' other transactions, in December 2006 Zions issued \$240 million of non-cumulative perpetual preferred stock.³² Rather than have the tracking security be a fraction of the value of the ESOs, for true price discovery it should be the same or even a multiple of the size of the ESOs.³³ In addition, if the market were assured of a regular calendar of sufficiently large issues, it could further attract the interest of a broad spectrum of potential bidders.

Increased issue size and the elimination of restrictions would attract the attention of a broad spectrum of market participants, a regular calendar would assure them that they could amortize the information and analysis costs of bidding over future auctions, and the elimination of the seller's incentives to achieve a low valuation could assure the buyer that a subsequent call would not be at a significant discount to value. The resulting auction price would be a market-based discovery of the fair value.

2. Provide a Liquid Secondary Market

A complementary remedy would be for Zions to support a liquid secondary market in the security. If Zions were prepared to make a two-sided market in ESOARS available -- providing a market-maker to buy and sell as demanded-- it would alleviate the inability of the current ESOARS auction process to determine a fair value of the ESOs. Currently there is only a one-sided market composed of small positions that must be held for the life of the ESOs or sold in an illiquid secondary market. If ESOARS are correctly valued at the auction price, a market-maker should not mind buying and selling ESOARS at a modest bid-ask spread around the auction price. In this context, the auction is merely a method of initiating a liquid secondary market with a reliable price discovery mechanism. The proper price for expensing would not be the initial auction value but, rather, the prevailing price in the secondary market.

It is common in the financial markets to place more weight on the secondary market price than on the initial offering. Closed-end funds, for example, typically sell in the secondary market at a discount from their net asset value but are sold at a premium in the initial offering. It often takes a few months for the trading price to emerge less its initial premium as the initial buyers of the funds move to sell them in the market. The same would occur for ESOARS (given a liquid secondary market), but in this case it is the initial discount from value that would disappear as buyers entered the market for the bargain values and Zions was in the position of having to raise the price (and provide a sorely-missing supply curve) as it satisfied their demand for significantly larger quantities than were initially offered.

³² <http://www.10kwizard.com>, 12/05/2006 filing of 424B3 by Zions Bancorporation.

³³ We realize, of course, that it's highly unlikely that any firm would use ESOARS to raise a major amount of capital.

3. Reverse the Auction

Another simple, complementary remedy using market forces would be to reverse the auction. Instead of selling ESOARS with all of the attendant misalignment of incentives, Zions could buy ESOARS from third party suppliers and use them to hedge the obligation to the employees (or simply hand them over to the employees). The ESOARS payouts would be as they are currently and bidders would compete to supply quantities of options at stipulated prices. Instead of a demand curve, the equilibrium price would be determined by a supply curve (aggregating up from the bottom) from which Zions could purchase. Alternatively, Zions could act as a discriminating monopsonist and simply pay the offer price from each supplier until enough options are accumulated to make the proposed grant to employees. Even at its most inefficient, such a one-sided market would be superior to the current approach, with its misaligned incentives.

FAS 123R requires companies to expense the cost of the ESOs. In the ESOARS auction, bidders offer some estimate of the value to them of receiving the same payments as the employees. If, instead, the company were to buy ESOARS, sellers would agree to supply the payments that the company has to make at an ask price. This ask price is the true cost to the company, i.e., what they have to pay to offset the liability, not the bid price which is what someone is willing to pay to receive the ESOs payouts. In effect, what the Zions ESOARS auction does is find the value of the payouts to financial players, but what is required is the cost to the company of making the payouts. If the auction were sufficiently competitive, the spread between the value of buying the payouts and the cost of supplying them would be very small, but as we have described above, this is not the case with the ESOARS auction. Far more efficient would be to run the auction in reverse to buy ESOARS. Doing so would align the incentives in the usual way, so that the buying company would want a low price and the financial sellers a high price.

Conclusion

In sum, ESOARS require major modifications before they can correctly reflect the true cost to the company of its ESOs. Without remedies or alternatives such as those proposed above, the ESOARS price should not be accepted by auditors nor certified by senior executives as correctly measuring the cost of a company's ESOs.

CVI Personnel

Stephen A. Ross is the CEO of CVI and is currently the Franco Modigliani Professor of Financial Economics at the Sloan School of MIT.

Richard Roll is a principal of CVI and is the Japan Alumni Professor of International Finance at the UCLA Anderson School of Management.

Rick Antle is the COO of CVI and is the William S. Beinecke Professor of Accounting at the Yale School of Management.

Greta Hotopp is a principal of CVI, and holds an MBA from Yale; she was formerly an options trader in the U.S. and the U.K., and headed Barclay's international FX broking desk in Tokyo.

Andrew Jeffrey is a principal of CVI and prior to joining CVI was an assistant professor of finance at the Yale School of Management.

COUNCIL OF INSTITUTIONAL INVESTORS

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Via Hand Delivery

February 5, 2007

Conrad Hewitt
Chief Accountant
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Zions Bancorporation ESOARS

Dear Mr. Hewitt:

I am writing on behalf of the Council of Institutional Investors, an association of 140 public, corporate and union pension funds with combined assets of over \$3 trillion (“Council”). This letter is in response to the press reports³⁴ and other information³⁵ we have been able to obtain about your office’s recent approval of Zions Bancorporation’s (“Zions”) Employee Stock Option Appreciation Rights Securities (“ESOARS”) for use as a market-based approach for valuing employee share-based payment awards under Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* (“Statement 123R”).

The Council has been, and continues to be, a strong proponent of Statement 123R.³⁶ We believe Statement 123R improves financial accounting and reporting of share-based payment awards by requiring that, consistent with the Council’s corporate governance policies, all employee share-based payment awards be accounted for as compensation costs appropriately reducing reported earnings.³⁷

³⁴ *SEC approves Zions’ stock-option valuation system*, Salt Lake Trib., Jan. 31, 2007; David Reilly and Serena NG, *SEC Clears Market-Based Way To Value Staff Stock Options*, Wall St. J., Jan. 30, 2007, at C5; Matthew Rand, *A Hot New Way to Price Options*, Forbes.com, Jan. 19, 2007.

³⁵ Press Release, *Zions Bancorporation Receives SEC Clearance for Market-Based Employee Stock Option Valuation Method*, Jan. 30, 2007; Letter from Conrad Hewitt, Chief Accountant, *United States Securities and Exchange Commission*, to James G. Livingston, Vice President, *Zions Bancorporation* (Jan. 25, 2007); Summary prepared by James G. Livingston, Vice President, *Zions Bank*, for the Office of the Chief Accountant, *Securities and Exchange Commission* (Sept. 22, 2006).

³⁶ See, e.g., Letter from Jeff Mahoney, General Counsel, *Council of Institutional Investors*, to Nancy M. Morris, Secretary, *Securities and Exchange Commission* (Jan. 25, 2007), 2 of 4.

³⁷ See, e.g., Letter from Ann Yerger, Executive Director, *Council of Institutional Investors*, to Nancy M. Morris, Secretary, *Securities and Exchange Commission* (June 21, 2007), 3.

We also are a strong proponent of the fair value measurement objective and related implementation guidance contained in Statement 123R. We agree, as stated in that guidance, that “[o]bservable market prices of identical or similar equity or liability instruments in active markets are the best evidence of fair value and, if available, should be used as the basis for the measurement of equity and liability instruments awarded in a share-based payment transaction with employees.”³⁸

We believe your approval of Zions’ ESOARS is likely to have a significant impact on the reporting of compensation costs and reported earnings in company financial reports for at least two reasons. First, in addition to using the ESOARS for its own Statement 123R stock option valuation, it appears that Zions plans to actively sell the use of the ESOARS to many other companies for purposes of valuing and reporting share-based payment awards pursuant to Statement 123R.³⁹ Second, it appears that Zions’ experience to-date is that the ESOARS produce a value far below that produced by the well known, and Securities and Exchange Commission (“SEC”) staff approved,⁴⁰ modified Black-Scholes-Merton model.⁴¹ It has been reported that Zions’ vice president has boasted that “companies using Zions’ auction system can reasonably expect to *add back as much as half of their options expenses to pretax profits.*”⁴²

We share your predecessor, Donald T. Nicolaisen’s, doubts about the use of market instruments in valuing share-based payment awards when, as appears to be the case for Zions’ ESOARS, the “actual transaction price proved to be significantly different from the price that would be expected based on broadly accepted modeling techniques”⁴³ In those circumstances, Mr. Nicolaisen concluded that “questions would arise about whether the instrument itself and the marketing of the instrument were sufficient to achieve a true fair value exchange price.”⁴⁴

For the reasons stated above, and because your office’s decision to approve Zions’ ESOARS does not appear to have been subject to any public due process, we would respectfully request that your office defer any further approvals of this approach for a minimum of thirty days. During the thirty day deferral period, the Council and other interested investors would have the opportunity to (1) carefully analyze Zions’ ESOARS,

³⁸ Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, ¶ A7 (footnote omitted).

³⁹ *SEC approves Zions’ stock-option valuation system* (Reporting that Zions’ vice president indicated that the “bank might eventually conduct as many as 50 [ESOARS] auctions a year [for other large companies], charging \$200,000 for each one”).

⁴⁰ Memorandum from Office of Economic Analysis to Donald Nicolaisen, Chief Accountant, *Economic Perspective on Employee Option Expensing: Valuation and Implementation of FAS 123(R)* (Mar. 18, 2005), 3.

⁴¹ Summary prepared by James G. Livingston, at 17 (“The valuation derived from the auction suggests a value of \$8.57 per ESO, which is 68% of the value of \$12.65 given by the Black-Scholes-Merton model.”).

⁴² Matthew Rand, at 1 of 2 (emphasis added). Of note, the reported statement by Zions’ vice president is inconsistent with the information contained in Zions’ summary prepared for your office.

⁴³ Donald T. Nicolaisen, Speech by SEC Staff: Statement Regarding Use of Market Instruments in Valuing Employee Stock Options (Sept. 9, 2005), at 2 of 3.

⁴⁴ *Id.*

(2) consult with leading valuation and accounting experts, and (3) report to your office any concerns about whether the approach produces sufficiently reliable values for financial reporting purposes.

The ongoing stock option backdating controversy is a constant reminder that the financial accounting and reporting for employee share-based awards is an area in which there is a high risk of intentional misapplication of accounting requirements. Investors, therefore, may not realize the full benefits of Statement 123R unless audit committees, external auditors, the Public Company Accounting Oversight Board, and the SEC, actively support the high quality implementation of Statement 123R's principles-based requirements.

We look forward to your response to our request. Please contact me with any questions or if you need any additional information.

Sincerely,



Jeff Mahoney
General Counsel

CC: Chairman Christopher Cox
Commissioner Paul S. Atkins
Commissioner Roel C. Campos
Commissioner Kathleen L. Casey
Commissioner Annette L. Nazareth

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Via Email

January 25, 2007

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Executive Compensation Disclosure (File Number: S7-03-06)

Dear Ms. Morris:

I am writing on behalf of the Council of Institutional Investors, an association of 140 public, corporate and union pension funds with combined assets of over \$3 trillion (“Council”). The Council appreciates the opportunity to comment on the Securities and Exchange Commission’s (“SEC” or “Commission”) interim final rules adopting amendments to the disclosure requirements for executive and director compensation (“Amended Rules”). We, however, must express our disappointment that our comments and the comments of other investors cannot have any practical impact on the Amended Rules applicable to the 2007 proxy statement disclosures because the Amended Rules became effective on December 29, 2006.⁴⁵

We note that the effective date for the Amended Rules was the same date the rules first appeared in the Federal Register, and thirty-one days before the comment period will close.⁴⁶ Absent extraordinary circumstances, we believe investors should be provided a meaningful opportunity to comment on significant changes to SEC rules and regulations *before* those changes become effective. The ability for investors to have an opportunity to comment is particularly important when, as discussed further below: (1) investors publicly supported the requirements in the original rule that are now amended; (2) investors did not request the amendments; and (3) the Amended Rules indicate that the Commission has concluded that the amendments will benefit investors.⁴⁷

We acknowledge and appreciate that the Amended Rules require companies to report the full grant fair value of stock and option awards in the year of the grant in a new column added to the Grants of Plan-Based Awards Table.⁴⁸ We, however, continue to support the original rule that would have required companies to report the grant date fair value

⁴⁵ Executive Compensation Disclosure, Release Nos. 33-8765; 34-55009 (Dec. 29, 2006) [71 FR 78338, 78339] (“Amended Rules”).

⁴⁶ Id.

⁴⁷ Id. at 78340-41.

⁴⁸ Id. at 78342.

amounts in the more prominent Summary Compensation Table.⁴⁹ The basis for our continuing support of the original rule is set forth in our March 2006 comment letter in response to the SEC’s January 2006 proposed rule.⁵⁰ Our comment letter states:

The summary compensation table is an important tool used by investors to gain a “snapshot” of total compensation paid during the year. The Council generally supports the SEC’s proposals regarding the table—particularly the disclosure of the total compensation figure and the full present valuation of stock option awards

. . . [T]he Summary Compensation Table should disclose the decisions of the compensation committee in the applicable year. Most of the information presented in the proposed columns is consistent with this perspective, including the disclosure of the grant date full fair value for equity instruments, which the Council strongly supports.

. . . .

One of the most important (and long overdue) reforms contained in the proposal is the requirement that companies disclose the full grant date present value of equity instruments. The SEC’s proposed approach is appropriate, meaningful, consistent with other disclosures and readily understandable to investors. The Council would oppose eliminating the proposed requirement or weakening it to permit the disclosure of an alternative valuation, such as the amounts expensed under FAS 123R. The proposed methodology is consistent with the objective of providing investors with the tools needed to evaluate the annual decisions of the compensation committee, and it should be retained in the final rule.⁵¹

The Council has been, and continues to be, a strong proponent of Statement of Financial Accounting Standards No. 123R, *Share-Based Payment* (revised 2004) (“Statement 123R”).⁵² Statement 123R, however, is an accounting standard intended to provide for the appropriate reporting of the cost of employee services received in exchange for an award of equity in a company’s statement of earnings.⁵³ Consistent with the reporting of most other forms of compensation in earnings statements, Statement 123R requires that

⁴⁹ Executive Compensation and Related Disclosure; Final Rule and Proposed Rule, Release Nos. 33-8732A; 34-54302A; IC-27444A (Sept. 8, 2006) [71 FR 53158, 53171-72] (“Original Rule”).

⁵⁰ Letter from Ann Yerger, Executive Director, Council of Institutional Investors, to Nancy M. Morris, Secretary, Securities and Exchange Commission (Mar. 29, 2006).

⁵¹ Id. at 4-5 app.

⁵² See Council of Institutional Investors, 2005 Annual Report 9 (Jan. 2006).

⁵³ See Statement of Financial Accounting Standards No. 123, ¶ B32 (revised Dec. 2004).

the share-based compensation cost be recognized over the periods during which the employee performs the related services.⁵⁴

In contrast, the original rule's requirements for the Summary Compensation Table were intended to provide for the appropriate reporting of the amount of stock and option awards to certain executives during the reporting period.⁵⁵ Consistent with the timing of proxy disclosure of option awards since 1992, the original rule would have required the reporting of the full grant date fair value of the stock and option awards *in the year* of the award.⁵⁶

The original rule acknowledged that the Statement 123R recognition of compensation expense was inconsistent with the purpose of stock and option awards disclosure in the Summary Compensation Table.⁵⁷ The original rule explains:

Disclosing these awards as they are expensed for financial statement reporting purposes would not mirror the timing of disclosure of non-equity incentive plan compensation. While we have imported a financial statement reporting principle to enable disclosure of compensation costs, executive compensation disclosure *must continue to inform investors of current actions regarding plan awards – a function that would not be fulfilled applying financial reporting recognition timing.* If a company does not believe that the full grant date fair value reflects compensation earned, awarded or paid during a fiscal year, it can provide appropriate explanatory disclosure in the accompanying narrative section.⁵⁸

The Amended Rules offer the following two arguments in support of the Commission's "surprise move"⁵⁹ to reverse the requirements in the original rule: (1) the new requirements "will better fulfill the Commission's objective of informing investors of current actions regarding plan awards";⁶⁰ and (2) the new requirements "will be easier for companies to prepare and investors to understand."⁶¹

With respect to the first argument, as indicated above, we believe, and the SEC initially agreed, that the Commission's objective of informing investors of current actions regarding plan awards is best served by the original rule's requirement that companies

⁵⁴ Id. ¶ B144.

⁵⁵ See Original Rule, 71 FR at 53170.

⁵⁶ Id. at 53172 (The Original Rule explaining, "[t]he only change [since 1992] is that the awards are now disclosed in dollars rather than number of units or shares").

⁵⁷ Id.

⁵⁸ Id. (emphasis added).

⁵⁹ David B.H. Martin & David H. Engvall, Covington & Burling LLP, SEC Amends Disclosure Rules for Stock-Based Compensation, Securities Client Advisory, Dec. 28, 2006, at 1.

⁶⁰ Amended Rules, 71 FR at 78341.

⁶¹ Id.

report the full grant date fair value of executive compensation awards in the Summary Compensation Table. We note that the Amended Rules reference over two dozen investor or investor-based organizations that submitted comment letters generally expressing support for that view.⁶² As acknowledged in the Amended Rules, those organizations generally agreed that requiring companies to report the full grant date fair value in the fiscal year of the award in the Summary Compensation Table, “would provide a more complete representation of compensation and would be more consistent with the purpose of executive compensation disclosure.”⁶³

We also note that the Amended Rules reference eleven organizations that submitted comment letters expressing support for the view taken in the Amended Rules that the Summary Compensation Table should report, “the proportionate amount of an award’s total fair value that is recognized in the company’s financial statements for the fiscal year.”⁶⁴ Those eleven organizations include the American Institute of Certified Public Accountants and the Chamber of Commerce of the United States of America, but do not appear to include *a single investor or investor-based organization*.⁶⁵

With respect to the second argument, we believe it is questionable whether the new requirements will make the Summary Compensation Table easier for companies to prepare and investors to understand. The Amended Rules suggest that such benefits will result, at least in part, from aligning the amounts required to be reported in the Summary Compensation Table with the amounts required to be reported by Statement 123R in a company’s earnings statement.⁶⁶ An analysis by a prominent law firm, however, concludes that the reversal introduces “greater complexity to the rules”⁶⁷ The greater complexity arises, at least in part, because the Amended Rules significantly depart from the Statement 123R requirements by disregarding estimates of forfeitures when computing amounts to be shown in the Summary Compensation Table.⁶⁸

Finally, we note that one implication of the Amended Rules is that the amount for stock and option awards reported in the Summary Compensation Table will generally be less than the aggregate grant date fair value of such awards that would have otherwise been required to be reported under the original rules.⁶⁹ Moreover, it appears that the companies that will receive the greatest benefit from the reversal are the more than 800 companies, many in the high technology industry, which accelerated the vesting of

⁶² *Id.* at 78339 n.13.

⁶³ *Id.* at 78339.

⁶⁴ *Id.* at 78339-40.

⁶⁵ *Id.* at 78340 n.14. We also note that the Securities and Exchange Commission’s then Deputy Chief Accountant, Scott Taub, appeared to acknowledge that the Amended Rules would not result in better information than the Original Rules when he stated: “I don’t think one answer or the other necessarily provides more complete or fuller disclosure—they’re just two different ways of providing the information” C.E. Rosen, *The SEC Stirs the Pot on Executive Comp*, CFO.Com, Jan. 4, 2007, at 2 of 3.

⁶⁶ See Amended Rules, 71 FR at 78340.

⁶⁷ Jeremy L. Goldstein & David E. Kahan, Wachtell, Lipton, Rosen & Katz, *SEC Changes Approach to Valuing Equity Awards under Compensation Disclosure Rules*, Jan. 3, 2007, at 1.

⁶⁸ See David B.H. Martin & David H. Engvall, at 2; Jeremy L. Goldstein & David E. Kahan, at 2.

⁶⁹ David B.H. Martin & David H. Engvall, at 4-5.

employee stock options prior to the adoption of Statement 123R.⁷⁰ It has been estimated that those companies “dodged” the reporting of more than \$4.7 billion in after tax compensation costs in their earnings statements.⁷¹ Those companies will again avoid the reporting of some portion of those costs in the Summary Compensation Table. In commenting on the practice of accelerated vesting of employee stock options prior to the adoption of Statement 123R, a prominent accounting analyst opined:

Weren’t options supposed to “align management interests with those of the shareholders?” That link is broken with accelerated vestings just as surely as it is broken with backdated stock options. . . . And it’s an insult added to injury when the supposedly “worthless” options become intrinsically valuable and employee recipients are no longer required to provide services. Some alignment!⁷²

We appreciate the opportunity to comment on the Amended Rules. Despite the concerns referenced above, we continue to strongly support the Commission’s ongoing efforts to update and improve executive compensation disclosures.

Sincerely,



Jeff Mahoney
General Counsel

⁷⁰ See Jack T. Ciesielski, The Analyst’s Accounting Observer, Aug. 15, 2006, at 2.

⁷¹ Id.

⁷² Id. at 3.

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VIA HAND DELIVERY

September 8, 2006

The Honorable Richard C. Shelby
Committee on Banking, Housing, and Urban Affairs
United States Senate
SD-534 Dirksen Senate Office Building
Washington, D.C. 20510-6075

Re: September 6, 2006, Hearing of the Committee on Banking, Housing, and Urban Affairs on Stock Options Backdating

Dear Mr. Chairman:

I am writing on behalf of the Council of Institutional Investors (“Council”), an association of more than 130 public, corporate and union pension funds with combined assets of over \$3 trillion. We applaud your decision to have held the above referenced hearing on a very important and timely issue of great interest to our members in their role as institutional investors. We respectfully request that this letter be made a part of the official hearing record.

The Council believes that executive compensation is a critical and visible aspect of a company’s governance. Pay decisions are one of the most direct ways for shareowners to assess the performance of the board. And they have a bottom line effect, not just in terms of dollar amounts, but also by formalizing performance goals for employees, signaling the market and affecting employee morale.

Well designed executive stock compensation programs can lead to superior performance when structured to achieve appropriate long-term objectives and align executives’ interests with those of the shareowners. Those programs, however, as evidenced by stock options backdating, can also be abused, undermining the purpose and potential benefits of stock compensation.

We share your view that that stock options backdating “hurts the capital markets . . . [and] destroys confidence in our system.”⁷³ We also appreciate and support your interest in ensuring that the Securities and Exchange Commission (“SEC”) has the necessary

⁷³ Vineeta Anand and Jesse Westbrook, “Congress Wants to Ensure SEC Has Funds to Police Option Awards,” Bloomberg.com (September 6, 2006).

resources and authority to address the issues raised by stock options backdating and other potential executive compensation abuses that may arise in the future.

Many of the parties that participated in stock options backdating activities appear to have been motivated by the desire to provide extra compensation to certain executives without: (1) requiring any performance from the executives in return for the extra compensation; (2) requesting approval or even informing existing or potential shareowners that the extra compensation was being granted; and (3) reporting the extra compensation as a cost or expense, and thereby overstating the company's earnings to market participants.

In addition to violating the federal securities laws that were designed to protect investors, stock options backdating activities also appear to have violated a number of the Council's recommended "Corporate Governance Policies," including the following:

Performance options: Stock option prices should be . . . based on the attainment of challenging quantitative goals.

Stock option expensing: Since stock options have a cost, companies should include these costs as an expense on their reported income statements and disclose valuation assumptions.

Grant timing: Except in extraordinary circumstances, such as a permanent change in performance cycles, long-term incentive awards [including stock compensation] should be granted at the same time each year.

Award specifics: Compensation committees should disclose the . . . performance criteria and grant timing of . . . [stock compensation] granted . . . and how each component contributes to long-term performance objectives of a company.

For your information, given our members' significant interest in stock options backdating, in June 2006 the Council sent letters to the 1,500 largest U.S. companies by market capitalization asking those companies to explain: (1) how they granted equity awards; (2) whether they were conducting an internal review of past stock option practices; and (3) whether they were under investigation by the SEC or any other law enforcement agency for stock option-related practices. To-date we have received over 220 responses. The responses are available on the Council's website at www.cii.org. We would welcome the opportunity to share our analysis of the responses with the Committee upon request.

We again want to thank you for holding a hearing on stock options backdating and appreciate the opportunity to provide the Committee with our views on the issue. We look forward to continuing to work with you, Ranking Member Sarbanes, other Members of the Committee, the SEC, and the Public Company Accounting Oversight Board on issues relating to stock option backdating and other issues of importance to our nation's investors.

Sincerely,



Jeff Mahoney
General Counsel

cc: The Honorable Paul S. Sarbanes, Ranking Member, Committee on Banking,
Housing, and Urban Affairs
The Honorable Christopher Cox, Chairman, United States Securities and
Exchange Commission
The Honorable Mark W. Olson, Chairman, Public Company Accounting
Oversight Board

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June 21, 2006

Nancy M. Morris
Secretary,
Securities and Exchange Commission
100 F Street, NE,
Washington, DC 20549-9303

RE: File Number S7-03-06
Executive Compensation and Related Party Disclosure

Dear Ms. Morris:

I am writing on behalf of the Council of Institutional Investors, an association of more than 140 corporate, union, and public pension plans with more than \$3 trillion in assets. The Council requests that the Commission accept this letter as additional comment in response to the Commission's proposed Executive Compensation and Related Party Disclosure rule.

Recent reports regarding stock-option granting practices at some companies have raised significant concern for investors. Concerns center on two major topics: 1) the potential that some stock option grants have been backdated; and 2) the potential that companies may be purposely timing equity grants to take advantage of significant events or news releases that are likely to affect the market value of their stock. We believe the Commission should consider potential amendments to the proposed disclosure rule as well as other disclosures and actions in response to these issues.

The Council recognizes that backdating and grant-timing may not in all circumstances be illegal. However, we strongly believe these practices are inconsistent with the long-term interests of shareowners and obviously can have very significant potential legal ramifications. In each case, we believe these practices are akin to insider trading and very specific disclosures should be required to assist investors in monitoring the behavior of companies in this regard.

Accordingly, we request the Commission consider the following actions:

- 1) Amend the Executive Compensation and Related Party Disclosure rule proposal to provide the following:
 - a) A requirement that companies disclose whether they have adopted a comprehensive policy regarding equity grants. The required disclosure should include specific components of the policy, including grant-date timing, methodologies for establishing strike prices, the

roles of responsible parties related to key steps in establishing and administering equity grants, and the basic procedures the company will use to ensure the equity grants are administered in compliance with the policy. The Council believes this policy should address all equity grants to any employees, not just Section 16 officers, but any differences in the treatment of varying classes of employees should be clearly delineated.

- b) The date(s) in the preceding year in which the committee approved each equity grant, and the date the grant became effective. Any discrepancy between these dates should be fully explained. The Council continues to support the Commission's proposed disclosure of the grant date for stock or option awards in the Supplemental Annual Compensation Tables.
 - c) For each equity grant, a requirement that companies provide a brief explanation for the purpose of the award and the grant date of the award. We believe the Commission should require adequate disclosure such that investors will be able to clearly identify situations in which equity grants are made, even if only partially, for the purpose of timing specific events or news, whether specific to the company or otherwise.
- 2) Review current requirements and enforcement of disclosures related to equity grants made to Section 16 officers. The Council believes the provisions in the Sarbanes-Oxley Act that strengthened the reporting requirements under Section 16(a) of the Exchange Act have likely been an impediment to backdating practices since their implementation in August 2002. Under the new rules, reporting changes in beneficial ownership through a Form 4 filing, including receipt of a grant of stock options, must be done within two business days of receipt of the grant.

However, it appears that in some instances the Form 4 filings are not being made in a timely manner. According to a recent study,⁷⁴ roughly one fifth of a sample of approximately 3,700 option grants between August 2002 and November 2004 violated the two-business-day reporting requirement. Moreover, the study indicated that those grants that were not reported in time were associated with return patterns suggestive of backdating, and the magnitude of the return pattern was greater the longer the delay in reporting. Thus, it appears that, if the two-day reporting requirement is not complied with, the beneficial impact of the requirement as it relates to inhibiting backdating is diminished.

The Council requests the Commission consider the following actions related to Form 4:

⁷⁴ Does backdating explain the stock price pattern around executive stock option grants? Randall A. Heron, Kelley School of Business, Indiana University, and Erik Lie, Henry B. Tippie College of Business, University of Iowa. Paper is forthcoming in the Journal of Financial Economics. JEL classification: J33; M52 Keywords: Executive stock option grants; Backdating.

- a) Increased enforcement action and penalties for non-compliance with the current two- business-day filing requirement for Form 4.
- b) For each instance in which the filing requirement for Form 4 is violated, require disclosure in the company's proxy statement of the reason for the violation and the status of any action resulting from the violation.

In addition to improved disclosure related to equity granting policies and procedures noted above, the Council believes SEC enforcement action is a critical element of an appropriate response to the backdating scandal. The Council strongly supports the SEC's regulatory actions to date. We believe it is imperative that the Commission investigate fully all instances where there is evidence of backdating and take strong action against all participating parties, including board directors and legal counsel, in those circumstances where improper behavior is discovered. In cases where it is determined fraudulent or misrepresentative disclosures and financial statements occurred, we believe it is appropriate for the

Commission to seek to nullify the related grants or seek restitution of the gains associated with the grants.

Finally, the Council believes that the backdating controversy illustrates that the financial accounting and reporting for employee stock option grants is an area in which there is a high risk of intentional misapplication of the accounting requirements. The Council notes that those companies involved in the backdating controversy appear to have failed to comply with the rules-based exception contained in Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ("Opinion 25"). The Opinion 25 exception permitted companies for over 30 years to structure their option grants to understate compensation cost and inflate reporting earnings. Financial Accounting Standards Board Statement No. 123R, *Share-Based Payments* ("FAS 123R"), which became effective for most companies on January 1, 2006, replaced the Opinion 25 rules-based exception with a principles-based standard.

FAS 123R improves financial accounting and reporting of stock option grants by requiring that, consistent with the Council's corporate governance policies, all employee stock option grants be accounted for as compensation costs reducing reported earnings. The Council, however, is concerned that some preliminary evidence surrounding the adoption of Statement 123R appears to indicate that some companies may be intentionally understating certain inputs required by the standard in an effort to continue the Opinion 25 practice of understating compensation costs and inflating reported earnings.⁷⁵ The Council believes that the benefits of Statement 123R will not be fully realized by investors unless and until the SEC closely monitors and rigorously enforces a high quality implementation of the standard's requirements.

⁷⁵ Jack T. Ciesielski, *The Accounting Analyst's Observer* (May 2, 2006), page 16 (indicating that 81% of companies examined had reduced their volatility input for measuring the cost of employee stock options in 2005).

The Council looks forward to continuing to work with the Commission to improve the quality of information investors receive about executive compensation.

Sincerely,



Ann Yerger
Executive Director

CC: The Honorable Richard C. Shelby, Chairman, Committee on Banking, Housing, and Urban

Affairs

The Honorable Paul S. Sarbanes, Ranking Member, Committee on Banking, Housing, and Urban Affairs

The Honorable Michael G. Oxley, Chairman, Committee on Financial Services

The Honorable Barney Frank, Ranking Member, Committee on Financial Services

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March 29, 2006

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-9303

RE: File Number S7-03-06 Executive Compensation and Related Party Disclosure

Dear Ms Morris:

I am writing on behalf of the Council of Institutional Investors, an association of more than 130 corporate, union, and public pension plans with more than \$3 trillion in assets. Council members are long-term investors and leading advocates of good corporate governance practices and requirements.

Executive compensation has long been a top priority for the Council and its members. Concerns in recent years have centered not simply on the amount paid to CEOs and other top executives, but also the board processes for setting pay, the disclosure of pay, the structure of pay and the pay-for-performance metrics. Poorly structured pay packages may harm shareowner value by wasting owners' money, diluting ownership and creating inappropriate incentives that may damage a company's long-run performance. Inappropriate pay packages may also suggest a failure in the boardroom, since it is the job of the board of directors and the compensation committee to ensure that executive compensation programs are effective, reasonable and rational with respect to critical factors such as company performance and industry considerations.

Full and clear disclosure of executive pay is of significant interest to the Council and its members because it enables shareowners to evaluate the performance of the compensation committee and board in setting executive pay and the pay-for-performance links.

The Council thanks the Commission and the staff for preparing this comprehensive proposed rule. The proposal addresses a significant number of the most critical issues to investors, and we urge the Commission to move expeditiously to implement the new disclosure rules in time for the 2007 proxy season.

Overall the Council supports the proposed new format, including the concept of a Compensation Discussion and Analysis, the three primary categories of tables and the supplemental narrative disclosures.

The Council believes that the following elements of the proposal are top priorities and essential to ensure the success of the proposed rule. As summarized below and detailed in Appendix I, the Council recommends strengthening these key elements by modifying certain elements of the proposal.

Compensation Discussion and Analysis (CDA). The qualitative aspects of the disclosure rules are vitally important to Council members, but we recognize they are perhaps the most difficult to define as well as enforce. The Council strongly supports the proposal's concept of the CDA and its integration of principle-based and rules-based approaches.

To strengthen this integrated approach, the Council recommends the SEC expand the list of topics to be discussed “at a minimum” to include: detailed discussions of the rationale behind key components of the executive pay program in general as well as the links to performance contained in the program as a whole and specific to each key element of the program; and disclosure of key pay-related policies, such as “clawback” provisions, ownership/holding requirements, and hedging prohibitions.

We also believe it is essential for the SEC to support this integrated approach by providing detailed guidance (particularly in the first few years) and taking enforcement actions when appropriate.

‘Filed’ vs. ‘Furnished’ Status. The Council supports the SEC’s proposal to deem the new disclosures “filed” in hopes that the potential for increased scrutiny and potential liability will result in higher quality, more comprehensive disclosures. While the filed status will imply some ownership of the document by the full board and top management, the Council recommends the SEC also make it clear in the final rule that the compensation committee retains ultimate ownership of the disclosures.

Performance Targets and Thresholds. The Council recognizes the sensitive nature of the disclosures of performance targets. Similar to the current disclosure rules, the proposed rule maintains a “safe harbor” under which companies may exclude key information regarding performance targets and thresholds if disclosure may be competitively harmful to the company. The Council believes this approach provides too large an exemption for companies, ultimately leading to lower quality disclosures.

To address this significant weakness, the Council recommends an alternative that would balance company concerns of competitive information while providing details critical for investors to obtain a more complete understanding of compensation plans.

We recommend the SEC require companies to disclose performance targets either: (1) at the time they are established, which would be consistent with the disclosure of other incentive awards such as grant date valuations for equity instruments; or (2) at a future date—such as when the performance related to the award is measured—in cases when companies believe this information is competitively sensitive. If disclosure is postponed, the company should be required to explain that it is taking advantage of this exemption and the basis for taking this action, which would presumably be subject to SEC review.

Summary Compensation Table. The Council strongly supports the disclosure of “total compensation” in the Summary Compensation Table. We believe the elements proposed by the SEC as comprising total compensation are appropriate. In particular, we support the inclusion of the annual increase in actuarial value of pension benefits and the disclosure of the grant date, full fair value of option awards—not the amount expensed under FAS 123. Such disclosures are essential to give investors a full and fair snapshot of executive pay.

To improve the clarity and consistency of the summary compensation table disclosures, the Council recommends the SEC amend column (h), “Non-Stock Incentive Plan Awards,” to provide a grant date fair value estimate of the awards instead of the actual earned award value. In our view, the Summary Compensation Table should represent the decisions of the compensation committee during the applicable year. The remaining columns in the proposed Summary Compensation Table are consistent with this approach, and we believe non-stock incentive plan awards also should be presented on this basis. We propose that companies be given direction to calculate these values using probability estimates of achieving the award, discounted to a present value. Disclosure of the methodology and assumptions used by companies to estimate the awards should be required in a footnote. The Council requests that the actual payouts of non-stock incentive plan awards (consistent with the proposed column (h)) be disclosed in the Option Exercise and Stock Vesting Table.

Perquisites. The Council believes the current methodology of using incremental cost to value perquisites and other benefits may significantly understate the value of the benefits. To ensure more accurate disclosures, we recommend changing the current approach to require valuations of perks based on a commercially available equivalent.

The Council supports the proposed thresholds applicable to perks, which we believe strike the appropriate balance between investors’ need for complete disclosures and the burden on companies to track minor benefits. To enhance and clarify the presentation of the detailed information, the Council recommends that the SEC require tabular format disclosure of individual perks.

Related-Party Transactions. The Council opposes raising the dollar threshold from \$60,000 to \$120,000 for disclosure of related-party transactions. The Council has long urged the SEC to enhance the disclosures of related-party transactions between companies, directors and executives. The proposed increase would further weaken an already weak rule, and we urge the Commission to consider amending Regulation S-K as proposed by the Council in its October 1998 rulemaking petition.

Post-Employment Compensation. The Council strongly supports the proposed post-employment compensation disclosures, including the potential payments from retirement plans, nonqualified deferred compensation, and other potential post-employment payments. Post-employment compensation can represent significant value and have a material impact on the overall profile of a compensation program. Disclosures for each

named executive officer permit investors to understand the unique nature of the post-employment compensation at any particular company.

We recognize the complexities of disclosures in this area, and we accept that some disclosures will be based on estimates. Therefore, in each of the key areas of post-employment compensation, we support the SEC's proposed rules requiring companies to disclose all material factors related to each plan, particularly the key assumptions and methodologies used for the disclosures.

Performance Graph. The Council believes the new disclosures should retain the performance graph. We do not agree that the information communicated by the graph or its role in the overall compensation disclosure regime is outdated. To the contrary, the graph provides a quick performance comparison in close proximity to the compensation disclosures and is valuable to investors. Further, we believe removing the graph would eliminate a readily accessible and non-controversial source for performance comparisons that shareowners often use in their proposals and other correspondence.

The Council thanks the Commission and its staff for this comprehensive proposal. We value the open dialog the Council has enjoyed with the SEC on this critical issue.

We would be happy to respond if you have any questions or need additional information.

Sincerely,



Ann Yerger
Executive Director

Appendix I
Council of Institutional Investors' Response to File No. S7-03-06
Executive Compensation and Related-Party Disclosure

Appendix I is organized consistent with the SEC's proposed rule on executive compensation disclosure and related-party transactions. Each primary section contains the Council's general views on the topic. Bullet points respond to questions posed by the SEC in the release.

Compensation Discussion and Analysis

The Council strongly supports the proposed Compensation Discussion and Analysis (CDA) concept. However, we recommend some amendments to make the approach even stronger.

The Council recognizes that the qualitative nature of the disclosures in the current Compensation Committee Report and the proposed CDA is perhaps one of the most difficult areas for the SEC to define and enforce. Although the current rules established in 1992 emphasized the need for comprehensive qualitative disclosures, the resulting disclosures still are generally viewed as inadequate, which is evidence of this difficulty.

The Council believes the qualitative disclosures in the CDA and the narrative support for specific tables are critical elements of this proposal. To ensure the proper level of qualitative disclosures, we strongly support the proposed approach integrating the strengths of a principle-based approach with some rules-based criteria to ensure specific topics and concepts are discussed in the CDA.

The Council informally surveyed its membership, as well as many executive pay disclosure experts, on the topic of safe harbors in the context of executive compensation disclosure. While the Council is supportive of the SEC's proposal that the new disclosures be deemed "filed," we believe some steps should be taken to ensure the increased liability does not result in more boilerplate language rather than less. One concern is that increased liability related to executive compensation disclosures may result in "over-lawyered" documents in which the individuality and meaning of the disclosures are watered down in an attempt to limit potential liability. Clearly, such an outcome is not the SEC's intent nor will it serve the needs of investors.

We recommend the SEC take the following steps to ensure the CDA disclosures are comprehensive and robust:

- 1) Continue to emphasize and encourage the comprehensive requirements of the proposed CDA. It is clear in the proposed rule the SEC expects robust, qualitative disclosures, and this emphasis should also be present in the final rule and in any related guidance, enforcement actions, and commentary from the Commission and staff;

- 2) Continue to provide detailed requirements supplementing the principle-based aspect of the CDA, such as the proposed list of specific topics that must be discussed “at a minimum.” The Council recommends the SEC expand the list provided in the proposed rule to include:
 - A greater emphasis on articulating the performance aspects of the overall compensation program, including the company’s overall philosophy related to performance and how each component—including employment contracts and severance arrangements—of the program relates to performance and the company’s overall compensation objectives, if at all;
 - The company’s policy for recapturing incentive pay following specific events such as a restatement in which the “performance” measures affecting a plan are adjusted (clawback provisions)⁷⁶. If the company has no such policy, it should be required to state this fact and explain the reason;
 - Disclosure of any company policy, or lack thereof, regarding the hedging of equity and equity-like positions in the company, including those obtained through the compensation program as well as through other holdings⁷⁷.
- 3) Commit SEC staff resources to evaluating the quality of disclosures under the new rules and providing detailed guidance to companies and to the market as appropriate. The SEC should support the new rules with strict enforcement actions for those companies failing to meet the principle-based requirements of the CDA (as well as other aspects of the new rule); and
- 4) Consider ways the SEC can ensure compensation committees maintain “ownership” of the compensation disclosures. This could include maintaining the requirement that members of compensation committees include their names under the full reports or in portions thereof.

Disclosure of Performance Target Levels

The Council recognizes the sensitive nature of disclosures related to actual performance targets and thresholds attached to incentive awards granted to executives. Similar to the current disclosure rules, the proposed rule does not require companies to disclose “target levels with respect to specific quantitative or qualitative performance-related factors considered by the compensation committee or the board of directors, or any factors or criteria involving confidential commercial or business information, the disclosure of which would have an adverse effect on the company.”

The Council believes this approach provides too great an exemption for companies, resulting in poor quality disclosures. We cannot over emphasize the importance to investors of understanding the overall philosophy behind and drivers of incentive awards granted to top executives. Integral to gaining this type of understanding is the ability to

⁷⁶ For a recent example of this type of disclosure, see Pfizer Inc. Preliminary Proxy Statement PRE 14A, filed 2-24-2006, page 52.

⁷⁷ For a recent example of this type of disclosure, see Pfizer Inc. Preliminary Proxy PRE 14A, filed 2-24-2006, page 65.

not only understand the types of metrics—such as return on equity, sales growth, or total stock return—to which performance hurdles are tied but also the absolute levels of performance that must be achieved to earn the performance award. This information permits investors to evaluate the potential behavioral characteristics of the awards, the rigor of the targets, the value of the alignment, and the performance of the compensation committee in establishing the incentive program.

There may be some circumstances in which competitive information is embedded within performance plans. We do not believe this is the norm; in most cases, disclosure of performance targets poses no competitive threat to companies.

The Council recommends the SEC require companies to disclose performance targets either: (1) at the time they are established, consistent with the disclosure of other awards such as grant date for equity instruments; or (2) at a future date—such as when the performance related to the award is measured—in cases where companies believe the information is competitively sensitive. If companies postpone disclosure, they should be required to explain that they are taking advantage of the exemption and the basis for taking this action, which would presumably be subject to SEC review as part of the company's filed disclosures.

This compromise approach: 1) provides a balance between investors' need for information and companies' concerns over disclosure of competitive information; 2) helps ensure that companies utilize the exemption in appropriate circumstances and provides for a method of enforcement through SEC oversight; and 3) ensures the compensation committee knows the market will be able to view the hurdles at some point in time, even if only retrospectively.

Performance Graph

The Council believes the new disclosure rule should retain the performance graph. We do not agree the information communicated by the graph or its role in the overall compensation disclosure regime is outdated. The graph provides an easily accessible visual comparison of a company's performance relative to its peers and the market. The rationale expressed in the 1992 rules for placing the graph in close proximity to the narrative disclosure of the company's compensation philosophy remains valid today.

In addition, the graph should be retained because many investors prefer to utilize this source for unquestionable performance comparisons in shareowner proposals and other correspondence. Removing the graph forces investors to utilize other sources or make assumptions in a proposal, which opens a debate that some shareowners would rather avoid.

Compensation Tables

The Council strongly supports the tabular approach for compensation disclosures and the SEC's proposed reorganization of the tables into the three primary categories: 1) compensation within the last fiscal year; 2) holdings of equity-based interests; and 3) retirement and other post-employment compensation. This approach is logical, and we believe the risk of "double counting" of certain types of pay is minimized by the clear delineation between the major components, clear table and column headings, and supporting narrative disclosures. We also believe the SEC should clarify in the final rule that companies should utilize the narrative supporting disclosure to explain what the disclosures mean and provide guidance to avoid the potential for double counting.

Summary Compensation Table

The summary compensation table is an important tool used by investors to gain a "snapshot" of total compensation paid during the year. The Council generally supports the SEC's proposals regarding the table—particularly the disclosure of the total compensation figure and the full present valuation of stock option awards—but recommends a few changes to enhance this important table.

First, the Summary Compensation Table should disclose the decisions of the compensation committee in the applicable year. Most of the information presented in the proposed columns is consistent with this perspective, including the disclosure of the grant date full fair value for equity instruments, which the Council strongly supports.

However, the current proposed column (h) for Non-Stock Incentive Plan Compensation would report the value realized during the applicable year for awards established or granted in some previous year. It would be more consistent and more meaningful to investors to alter column (h) so that it provides a grant date estimate of the present value of the non-stock incentive awards made during the year. The Council recommends that companies be directed to calculate these values using probability estimates of achieving the award, discounted to a present value, and be required to disclose the methodology and details of the estimate (similar to the requirements for valuing equity awards).

Information related to the realized value of previous years' awards under column (h) is also valuable, and the Council recommends the SEC require disclosure of this amount in another table, perhaps in the Option Exercises and Stock Vesting Table.

Second, the SEC should amend the proposed approach for valuing perquisites to require that it be based on current market prices. We believe the current incremental cost approach is subject to gamesmanship and may significantly understate the true cost of the benefits, particularly relating to transportation benefits, such as company aircraft, and housing benefits. The Council recommends a methodology based on retail prices, including, for example, the retail cost to charter the same model aircraft.

Third, the SEC should expand the items required to be disclosed via tables as opposed to narrative footnotes. In particular, the Council recommends tabular disclosure of individual perquisites and major components of the All Other Compensation column.

The following bullets summarize the Council's responses to questions raised in the release regarding the summary compensation table:

General Comments

- The SEC should maintain the current three-year rolling disclosure format.
- The Council supports the supplemental disclosures accompanying the table (as well as other sections of the proposed rule).

Total Compensation

- The Council strongly supports the proposed requirement that all compensation be disclosed in dollars and that companies provide a total compensation amount. The total pay figure will not only provide meaningful disclosures to investors, it also will help compensation committees understand overall compensation programs and the potential interactions of each element.

Salary and Bonus

- Regarding annual salary and bonus, the Council supports the proposed change to Form 8-K eliminating the disclosure delay when salary or bonus cannot be calculated as of the most recent practicable date. The proposed footnote disclosure in these cases, including the date that the salary and bonus is expected to be determined, should also be included in the final rule.

Stock Awards and Option Awards

- One of the most important (and long overdue) reforms contained in the proposal is the requirement that companies disclose the full grant date present value of equity instruments. The SEC's proposed approach is appropriate, meaningful, consistent with other disclosures and readily understandable to investors. The Council would oppose eliminating the proposed requirement or weakening it to permit the disclosure of an alternative valuation, such as the amounts expensed under FAS 123R. The proposed methodology is consistent with the objective of providing investors with the tools needed to evaluate the annual decisions of the compensation committee, and it should be retained in the final rule.
- The same term assumptions used in computing FAS 123R values for financial statement purposes should be used in executive compensation disclosures to permit efficiency and consistency. However, disclosure of the key valuation assumptions should be provided in close proximity to the equity tables, not simply referenced in the company's financial statements. This information is critical to investors in evaluating the reasonableness of the key assumptions underlying the grant date present value estimate. Several of these assumptions can have a significant impact on the estimated value of option awards.
- The Council supports the elimination of the "potential realizable value" of option grants based on 5 percent and 10 percent increases in value. This disclosure is not as meaningful to investors as the grant date present value.

- The Council supports the SEC's proposal to require disclosure of repriced or otherwise materially modified equity (options and stock appreciation awards) based on the total fair value of the award. Although this methodology differs from the incremental cost basis in FAS 123R, the SEC's approach for the purpose of compensation disclosure is appropriate.
- The Council supports the SEC's proposal to eliminate the current rules giving companies the ability to report performance-based stock awards as incentive plan awards. Requiring consistent disclosure of these awards at the time they are granted is more appropriate and meaningful to investors.

Non-Stock Incentive Plan Compensation

- As noted above, the proposed disclosure of non-stock incentive plan compensation should be amended to require a grant date estimate of the value of the award, similar to the concept behind the other equity columns.
- The Council supports the proposed requirement that all earnings on outstanding equity awards be disclosed. This is more meaningful information to investors than the current requirement that provides disclosure of only above-market or preferential earnings.

All Other Compensation

- The SEC's proposed methodology for the All Other Compensation column is appropriate, as is requiring separate identification of each item exceeding \$10,000. This amount is a reasonable balance between the needs of investors for complete disclosure and burdens on companies.
- Given the extent of the disclosures under the All Other Compensation column, the Council recommends the SEC require a supplemental table detailing the various components captured in the column. Tabular disclosure is a much clearer format for these items than a footnote.
- The Council broadly supports the proposed disclosure of deferred compensation and specifically supports disclosing earned compensation, footnoting the amounts deferred, and providing appropriate disclosure under the separate and comprehensive deferred compensation presentation.
- The Council also strongly supports the proposed requirement that companies include the increase in actuarial value of defined benefit and actuarial plans. The SEC's rationale that this information is necessary to permit the presentation of a total compensation figure is accurate.
- The Council requests that the final rule contain the SEC's proposed clear definition and classification of perquisites in an effort to provide ample direction to companies.

- Regarding perquisites, the Council supports the proposed aggregate threshold of \$10,000 below which disclosure would not be required. This threshold strikes an appropriate balance between investors' need for complete disclosure and the burden placed on companies. We support the proposed detailed disclosure of any individual perquisites valued at the greater of \$25,000 or 10 percent of total perquisites and other personal benefits. In addition, the SEC should require tabular disclosure of individual perquisites; we believe this presentation would be clearer than the proposed footnote list.
- The current and proposed methodology of using incremental cost to value perquisites is flawed and may understate the value of the benefits, therefore, the Council recommends changing the rule to require fair market valuations.
- The Council strongly supports maintaining the current requirement that any tax gross-ups or other reimbursements of taxes owed be separately quantified and identified in the tax reimbursement category. Narrative disclosures related to perquisites should also include a discussion of the tax implications of specific benefits, including whether the benefits are deductible.

Supplemental Annual Compensation Tables

The Council supports the SEC's two proposed Supplemental Annual Compensation Tables. The proposed format provides clear and understandable supplements to the Summary Compensation Table. This information is not too repetitive, nor will it lead to any significant risk of double counting. For this reason, the Council prefers the Supplemental Table approach over the alternative of creating two Summary Compensation Tables.

The following bullets summarize the Council's responses to questions raised in the release regarding the supplemental annual compensation tables:

- The Council strongly supports the proposed delineation between performance-based awards and "all other" awards. This format will enable investors to better evaluate the relative mix of compensation between performance-based and non-performance-based awards.
- As noted above, the Council recommends the SEC amend the format of Column (h) in the Summary Compensation Table to provide an estimate of the grant date fair value of non-stock incentive awards. Such an approach would be consistent with the expanded disclosure of other equity awards. In addition, disclosure of the earned value of non-stock incentive awards should be consistent with the approach in the Option Exercises and Stock Vesting Table.

Narrative Disclosure to Summary Compensation Table and Supplemental Tables

The Council strongly supports the proposed requirement for narrative disclosures supporting the Summary Compensation Table and Supplemental Tables. Clearly, this type of detailed explanation and supporting material is crucial to provide a complete picture of the individual elements of executive pay programs. The SEC must continue to place very strong emphasis on the expectations for complete narrative disclosures in the final rule and in any subsequent guidance, enforcement actions, and commentary from the Commission and its staff.

The following bullets summarize the Council's responses to questions raised in the release regarding narrative disclosure to the summary compensation table and supplemental tables:

- The proposed instructions for the supporting narrative disclosures are sufficiently clear and distinct from the purpose of the CDA, and some overlap between these disclosures is acceptable. It is critical for companies to better explain the philosophy and rationale for: (1) the executive pay program as a whole; and (2) each of the key elements within the program, including how the elements fit together and support the objectives and situation of the company. Some of these points will be relevant in both the CDA and the supporting narrative throughout the disclosures.
- The SEC should amend the proposed rule to include an additional column in the Summary Compensation Table where companies must indicate by checkmark if the individual has an employment agreement.
- The proposed treatment of repricings is a positive step but would be enhanced by quantification and footnote disclosure of the fair value of the award both immediately before and immediately after the repricing or other modification.

Exercises and Holdings of Previously Awarded Equity

Given the size and variety of equity awards granted to executives, the Council has long supported clear disclosure of the potential value of previously awarded equity compensation.

The following bullets summarize the Council's responses to questions raised in the release regarding the disclosure of outstanding equity awards and options exercised/stocks vested:

- The Council supports the proposed format for the Outstanding Equity Awards at Fiscal Year-End Table. Companies should not be required to value out-of-the-money options and stock appreciation rights. However, it would be very useful to investors to require disclosure of the number and key terms of out-of-the-money instruments, since in many cases these instruments may be near their strike price,

and regardless, these instruments may have significant impact on an investor's evaluation of the compensation program. This disclosure could easily be accomplished by adding columns for out-of-the-money options and shares/units with footnote disclosure of their key terms.

- The Council supports the SEC's proposal to continue to provide disclosure of awards transferred by an executive. The requirement also should include footnote disclosure of the facts surrounding any transfer, including the identity of the transferee and the relation to the executive. This information is material to investors in evaluating the impact of such a transfer on the alignment and incentive characteristics of the overall plan.
- The Council strongly supports the SEC's proposed format of the Option Exercises and Stock Vested Table. The proposed information in this table is material to investors, and the Council supports the requirement to provide the original grant date fair value of the awards next to the ultimate realized value. Given the supporting disclosure as well as the column heading, this format would not lead to any material risk of double counting. Instead, this table will help investors evaluate the accuracy of companies' estimates and pricing methodologies over time, which the Council views as a significant positive factor. It would not be preferable to combine the proposed Outstanding Equity Awards at Fiscal Year-End Table with the proposed Option Exercise and Stock Vested Table.
- As previously noted, the Council supports the addition to the Option Exercise and Stock Vested Table of realized value under Non-Stock Incentive Plan Compensation. Specifically, the Council requests the Summary Compensation Table column (h), Non-Stock Incentive Plan Compensation, be amended to provide a grant date fair value estimate, similar to other equity tools and that the realized value of non-stock incentive compensation be reported in the Option Exercises and Stock Vested Table.

Post-Employment Compensation

Investor concerns over post-employment compensation have escalated in recent years as these arrangements have exploded in value. Because current disclosure rules in this area are lacking, it is impossible for investors to fully and clearly understand the scope and dollar value of these arrangements. We applaud the SEC for proposing significant revisions to the current rules addressing post-employment compensation.

The following bullets summarize the Council's responses to questions raised in the release regarding the disclosure of post-employment compensation:

Retirement Plan

- The Council supports the SEC's proposed format for the Retirement Plan Potential Annual Payments and Benefits Table, particularly the proposed disclosure based on each NEO and the proposed supplemental narrative

description of material factors “necessary to an understanding of each plan disclosed in the table.” The examples listed by the SEC in the proposal are appropriate and should be included in the final rule along with a statement that this list is not exhaustive and other material factors should be disclosed as appropriate.

Deferred Compensation

- The Council strongly supports the SEC’s proposed tabular and narrative format disclosure of nonqualified deferred compensation. The existing disclosure rules in this area do not provide complete disclosure of relevant compensation and supporting information and thus are in need of significant of revision. Should the SEC require disclosure of all earnings on nonqualified deferred compensation plans as proposed, the Council recommends separate disclosure of any preferential treatment, such as any premium, above-market, or other preferential terms. Earnings on these awards are distinct from other compensation decisions, and the Council believes some investors may treat these values differently from an analytical standpoint.
- The Council supports the proposed footnote quantification indicating the extent to which amounts in the contributions and earnings columns are reported as compensation in the year in question (and other amounts reported in the table under the aggregate balance column were reported in the Summary Compensation Table for prior years) and believes it provides adequate protection against double counting.
- A narrative description of the tax implications for both the participant and the company would be useful information to investors and analysts and should be included with the narrative disclosures accompanying the table.

Other Potential Post-Employment Payments

- The Council strongly supports the SEC’s proposal regarding disclosure of Other Potential Post-Employment Payments. These arrangements may vary significantly and often involve significant value and consequences on the alignment and incentive characteristics of the overall compensation program. It is critical for the SEC to require detailed qualitative disclosure regarding the specific mechanics of the plan(s) as well as the rationale and justification supporting their use. The examples of narrative disclosures provided by the SEC in the proposal are appropriate and should be provided in the final rule, particularly the disclosure of tax gross-up payments. The Council suggests the SEC specifically permit tabular disclosure as appropriate in this area, but recognizes that due to the variation in plans, no single format may fit⁷⁸. The Council believes that regardless of the formats used in this section, the final rule should strongly emphasize complete qualitative disclosure.

⁷⁸ For a recent example of tabular disclosure providing estimated current values of change in control benefits, see Pfizer Inc. Preliminary Proxy Statement PRE 14A, filed 2-24-2006, page 72.

- The Council understands the quantitative disclosures under the Potential Post-Employment Payments section will necessarily be based on estimates. Nonetheless, investors value this information, because the potential realizable values and the underlying mechanics are key to understanding the complexities of the whole compensation plan. The SEC should emphasize complete disclosure of the assumptions underlying the estimated payments disclosed in this section.

Covered Officers

The following bullets summarize the Council's responses to questions raised in the release regarding the disclosure of covered officers:

- The Council supports the SEC's proposal that the Principal Executive Officer (PEO) and Principal Financial Officer (PFO) with the three other most highly compensated executive officers constitute the Named Executive Officers (NEO). The addition of the Principal Financial Officer to automatic NEO status is appropriate given the role of this position under the requirements of the Sarbanes-Oxley Act in certifying the financial statements and the general importance of this position in the capital structure decisions of public companies.
- The Council supports the SEC's proposed standard of basing NEO status for the three other executive positions on total compensation. The current standard of basing this classification on salary and bonus alone has the potential to miss significant forms of compensation, thus not capturing the highest paid executive officers. The Council recognizes the concerns over volatility in NEO status and potential bias to longer-term employees that may be caused by utilizing total compensation as the standard for NEO status. However, this concern is mitigated by a number of factors: 1) the primary positions of PEO and PFO are locked into NEO status, providing some stability in the disclosures; 2) NEO status is limited to the executive officer team, which is already a somewhat limited group; 3) the focus on total compensation is more representative of companies' decisions and emphasis in their compensation plans (in other words, volatility in the classification of NEO status may in itself be an indicator of how a company views and implements its compensation program); and 4) it is more consistent with the SEC's overall focus on total compensation.
- The final rule should retain the current requirement providing disclosure for up to two additional individuals for whom disclosure would have been required but for the fact that they were no longer serving as executive officers at the end of the year.
- The Council supports the proposal to exclude payments attributable to overseas assignments from the determination of most highly compensated officers as proposed. Other exemptions based on "not recurring and unlikely to continue" compensation should be eliminated

- The proposed threshold of \$100,000 total compensation for disclosure of Named Executive Officers appears reasonable.

Interplay of Items 402 and 404

The Council supports the SEC's proposal to clarify the interplay between Sections 402 and 404. In particular, we support the consolidation of disclosures regarding compensation items under Section 402, and we agree with the SEC's rationale that the "possibility of additional disclosure in the context of each of the respective items is preferable to the possibility that compensation is not properly and fully disclosed under Item 402."

Compensation of Directors

In recent years, director compensation has grown more complex. Unfortunately, the disclosure rules have not kept pace with the changes in the director pay arena. As a result, it is difficult for shareowners to determine from narrative disclosures exactly how and how much their elected representatives are paid.

The following bullets summarize the Council's responses to questions raised in the release regarding the disclosure of director compensation:

- The Council supports the proposed tabular format for disclosure of compensation paid to each director. However, these disclosures should be enhanced by providing a three-year rolling format similar to the Summary Compensation Table rather than just a single-year format. The All Other Compensation column should be supported by footnote or expanded tabular disclosure of the individual items under this heading.
- The Council requests that the SEC require narrative disclosure of the rationale, purpose and philosophy of the director compensation program. This emphasis should be similar to the proposed CDA that is related to the executive compensation program, but it should be included with the Director Compensation Table (separate from the CDA).
- The proposed de minimis exception of \$10,000 for the disclosure of perquisites and other personal benefits is appropriate and consistent with the proposed rules for executive compensation disclosure.
- The Council recommends specific footnote disclosure or supplemental tables similar to the Outstanding Equity Awards Table and Option Exercise and Stock Vesting Table because they would provide meaningful enhancement to the director compensation disclosure rules. Given the significant importance of equity in director compensation plans, this type of disclosure would permit investors to evaluate overall levels of alignment better than the proposed summary table alone.

Treatment of Specific Types of Issuers

The Council recognizes that small businesses have fewer resources available to meet the proposed executive compensation disclosure requirements. However, the sweeping exemptions for small businesses proposed in the current draft go too far and will result in poor quality disclosures. As a general rule, the Council believes that special exceptions for small businesses, while well-intentioned, ultimately are a disservice to the public markets and to the businesses themselves.

In the case of executive compensation disclosures, the proposal would exempt small businesses from such critical elements of the disclosure rules as the comprehensive qualitative descriptions of the plan (including the CDA), Option Exercises and Stock Vested Table, and Post-Employment Compensation. The Council does not support such significant exemptions for small business in the critical area of executive compensation disclosures. The proposed exemptions would adversely affect the ability of investors to evaluate the merits of compensation structures at these companies and reduce the comparability of disclosures among small companies.

Beneficial Ownership Disclosure

The Council supports the proposed amendment to Item 403(b) to require footnote disclosure of the number of shares pledged as security by NEOs. These circumstances have the potential to influence management's performance and alignment, and thus, this information is material to investors. The Council supports the SEC's proposal that no specific category of loans be treated differently from any other because the purpose should be to provide complete disclosure of all cases in which shares have been pledged.

Note: The Council also is requesting specific disclosure under the CDA of companies' policy, or lack thereof, regarding the hedging of equity and equity-like positions. The purpose of this request is similar to the justification the SEC proposes for disclosure of pledges: these circumstances have the potential to alter the alignment of the compensation plan and influence behavior.

Certain Relationships and Related Transactions Disclosure

Director independence is an issue of fundamental importance to investors and the U.S. corporate governance model. But assessing a director's independence has long been problematic. Current disclosure rules are dated and weak, and as a result, some very basic, yet material, details about director relationships do not have to be disclosed and cannot be determined readily by shareowners.

To ensure that all interested parties have access to the information needed to assess a director's independence, the Council has submitted over the past decade two rulemaking petitions asking the SEC to require enhanced disclosure of relationships between directors, corporations and corporate executives. The October 1997 petition requested an

amendment to paragraph (d) of item 401 of Regulation S-K to require company disclosure of “personal, professional and financial relationships” between directors, companies and top management. Recognizing that personal relationships may be too difficult to depict clearly in regulatory language, the Council amended its petition in October 1998 to require disclosure of “familial, professional and financial relationships.”

The 1998 petition includes no de minimis dollar thresholds under which disclosure would not be required. Members of the Council recognize that independent directors do not invariably share a single set of qualities that are not shared by non-independent directors. As a result, given that no clear rule can unerringly describe and distinguish independent directors and that various groups have different approaches for assessing independence, the Council firmly believes the only appropriate solution to this persistent problem is to ensure that companies provide disclosure of any professional, financial and familial relationships between companies/executives and directors/relatives. Owners and others may then evaluate this information to make their own decisions about a director’s independence.

- The Council opposes raising the initial dollar threshold to \$120,000. The proposed increase would eliminate disclosure of certain related-party transactions, such as many of the cases involving the employment of relatives, which investors believe are important.
- The Council supports the SEC’s approach to indebtedness (integrating paragraph (c) of Item 404 into paragraph (a)). We believe it is appropriate to treat loans like any other related-party transaction and recognize the exception for “ordinary course loans” by financial institutions.

Procedures for Reporting Related-Person Transactions

The Council supports the proposed requirement for disclosure of the policies and procedures established by the company regarding related-party transactions. This type of information is material to investors, so at a minimum, the disclosures should include: 1) the types of transactions that are covered and the standards to be applied pursuant to the policies; 2) the person(s) on the board or otherwise responsible for applying the policies; 3) whether the policies are in writing and where a complete version can be viewed; and 4) if there are transactions requiring disclosure under 404(a) where a company’s policies and procedures did not require review or were not followed (or if any type of exception was granted).

Corporate Governance Disclosure

The Council supports the proposed consolidation of governance disclosures in Item 407. In particular, it will be meaningful for investors to be able to identify the criteria the company utilized for the independence determination, including a description of any transactions, relationships or arrangements not disclosed in Item 404(a) that were nonetheless considered by the board in determining that the applicable independence

standards were met. In cases where companies have their own definition of independence that is used to make certifications under this section, the companies also should be required to list the material differences between their definition and that of a national securities exchange (applicable to the company). This will provide an easy reference for comparability purposes.

The Council believes the proposed disclosure requirements regarding compensation consultants (under disclosures related to the process and procedure for the consideration and determination of executive and director compensation) is appropriate.

Treatment of Specific Types of Issuers

The Council recommends that paragraph (b) of Regulation S-K also should be included in Regulation S-B. As the SEC appropriately notes in the proposed rule, information regarding policies and procedures established by the company for related-party transactions is material to investors. The mere fact that a company files under Regulation S-B does not change this fact and should not exclude the company from disclosure of these policies. Presumably, the small business issuer still would have a policy or procedure for addressing these issues, and briefly articulating this policy should not cause a burden.

Plain English Disclosure

The Council strongly supports the proposed Plain English requirements; however, we do not believe that these requirements alone are sufficient to prevent boilerplate disclosures. Rather, these requirements should be viewed as an important component of an integrated approach by the SEC to promote the desired levels of disclosure. Other important components should include such aspects as SEC review and guidance (particularly in the first few years of the new rule), public commentary and support from the Commission and staff, as well as appropriate enforcement action.

The Council supports the broad application of Plain English requirements in the compensation disclosure rules. This requirement does not lead to increased disputes or increased litigation because it does not prohibit clear and complete disclosures of material information (in fact, it promotes this perspective).

