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Preparing for the Next Round of Executive Compensation Disclosure

Overview

Over the past few years a tremendous amount of concern and publicity has been generated around executive compensation decisions made in public companies. Executive compensation reform has been taken up by the government and shareholders, the latter usually in the form of stockholder proposals submitted in conjunction with company proxy statements. Front and center in this reform effort has been the Security and Exchange Commission (SEC), which has established new disclosure requirements as part of a larger effort to restore investor confidence in financial reports and to better understand pay and performance relationships. The Compensation Discussion and Analysis (CD&A), which is the centerpiece of the SEC's reform efforts, continues to challenge companies regarding what is necessary and appropriate disclosure. Some public companies in turn have disagreed with the SEC regarding what is irrelevant information and/or information that compromises the company's competitive position.

This 3C Trends+Issues is intended to provide our clients with guidance on how to fine-tune their CD&As so that they provide a complete and concise discussion of the important components of executive pay and adhere to SEC disclosure requirements.

Background

On November 7, 2006 revised rules by the SEC governing the disclosure of executive compensation by public companies went into effect. The SEC's intention in adopting the new rules is to provide investors with a clearer and more complete picture of compensation paid to directors and principal executive officers, principal financial officers, and the other highest paid executive officers (referred to as the Named Executive Officers or NEOs). On October 9, 2007, the SEC's Division of Corporate Finance released a report summarizing its initial comments sent by letter to 350 public companies regarding the quality of their executive compensation disclosure under the new rules. Since that time, many companies included in the initial review have received second letters from the SEC regarding their disclosure. The SEC has stated that it will continue its review of the CD&As with the objective of providing guidance to companies on how they can improve their disclosure.

SEC Staff Observations Regarding CD&A

Two themes emerged from the SEC's October staff report on executive compensation disclosure. First, companies should provide more focused disclosure in the CD&A on how the company arrived at the forms and amounts of compensation, why the company chose to pay that compensation, and what resulted from those decisions. (What the SEC does not want to see is lengthy explanations of executive compensation philosophy and decision mechanics.)

Second, the company's manner of presentation is very important in helping the reader understand the CD&A. This includes, among other things, making material disclosure items more prominent, avoiding boilerplate language, using plain English and making shorter - clearer



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statements. The SEC has also stated that companies should consider using tables and graphics not required explicitly by the disclosure rules if it will help the reader understand the materials being presented. The SEC also provided guidance on the benchmarking of compensation, performance targets and actual award decisions. The implications of this guidance are summarized in this article as well.

Highlights of SEC Comments and Related 3C Insights and Suggestions

Based on 3C's review of the SEC's "Staff Observations in the Review of Executive Compensation Disclosure" as well as a sampling of the SEC's comment letters and related company correspondence, we offer the following insights and suggestions regarding the CD&A.

General

Enhancing Investor Understanding of Executive Compensation - The CD&A is more than just another legal disclosure document, it is *the chance* to communicate to investors important aspects of the company's executive compensation program. Accordingly, preparers of the CD&A should concentrate on the following.

- Discuss how the company's executive compensation program supports the interests of the shareholders (program objectives, compensation elements, focal point of rewards, pay for performance, role of individual performance, etc.).
- Discuss resources that support the program and decision-making (i.e. benchmarking, use of comparator groups, survey resources, use of consultants, etc.).
- Discuss safeguards and other checks and balances that support the integrity of the executive compensation program (i.e. removal/avoidance of any conflicts of interest, how grant dates are established, how award adjustments are made, recovery of awards made based on inaccurate information, an independent compensation committee, etc.).
- Discuss why the company's Compensation Committee (Committee) or CEO made the executive compensation decisions that it did.

Producing a Reader Friendly Disclosure - The SEC in its letters to companies included in the initial study has stressed the need to discuss executive compensation programs using plain English¹ as opposed to highly technical language or jargon. In addition to being understandable to the average investor, the SEC stresses that the disclosure document needs to be logically organized and visually inviting. A reader friendly document also requires communicating more through less (i.e. fewer words, shorter sentences), which is something that is not easily accomplished when working with complex subjects and materials. The SEC has stated that too often companies use "boilerplate language" or engage in lengthy discussions about their compensation philosophy and how pay decisions are made, as opposed to discussing what data was analyzed, how it influenced decision making and why the company decided to pay awards in the amounts that it did. Consequently, individuals and teams tasked with creating the CD&A

¹ In fact the SEC has tried to impress this exact point on companies for many years now, and it has gone as far as producing "A Plain English Handbook" to help companies produce clear disclosure documents (see <http://sec.gov/pdf/handbook.pdf>).



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should focus disclosure on the how (forms and amounts of pay), why (decisions made) and what (results) of executive compensation.

Specific Requirements of the CD&A and Other Important Facets of Executive Compensation²

Summarized below are key comments by the SEC and insights and suggestions by 3C that are applicable to most public companies regarding the particulars of executive compensation disclosure.

Total Reward Program Objectives – One of the questions the CD&A should answer is *what are the objectives of the executive compensation program?* Program objectives typically vary from company to company since they reflect differences in company cultures and business strategies. For example, one company stated that its objectives included attracting and retaining executive leadership and aligning management’s interests with those of shareholders. Another company stated its program encouraged teamwork and performance and ensured internal pay equity. Whatever your executive compensation program objectives are, keep in mind that one follow-up question that the SEC has asked companies is *how do each of the elements of compensation tie back to the total reward program’s objectives?*

Reward Design – Another key question that has come up in the SEC correspondence is *what is the company’s compensation program designed to reward?* Companies have taken varied approaches to answering this question. For example, one company stated as part of its “overview” that the primary focus of its executive compensation program is to encourage and reward behavior that increases shareholder value in both the short and long-term through the achievement of the annual operating and long-term strategic plan. Another company summarized what its executive compensation program rewards under the “elements of compensation” as follows. The Company’s base salary rewards the economic and competitive market value of the position while providing a foundation for a competitive pay package; annual incentives reward near-term business performance by aligning the management team around common goals; and equity awards recognize long-term commitment to the organization.”

Elements of Compensation – In addition to the question noted earlier regarding how each element of compensation relates to program objectives, the SEC has asked companies to disclose *the rationale for the various elements and amounts of compensation*, including *how one element of compensation influenced decisions regarding the others*. The rationale for the various elements of compensation as well as the targeted amounts are based on the company’s compensation strategy and grounded in market practice as determined through benchmarking (discussed in more depth later). The elements of compensation as well as the levels that are targeted may be individually or collectively higher or lower than the market depending on how the

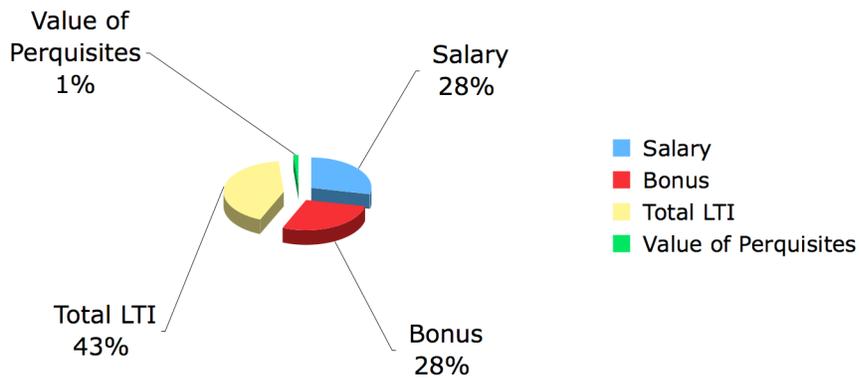
² The SEC has identified six specific reporting requirements for the CD&A along with examples of other facets of executive compensation that may require disclosure (the SEC list is not intended to be exhaustive, but illustrative - see sec.gov/rules/final/2006/33-8732a.pdf for more information).



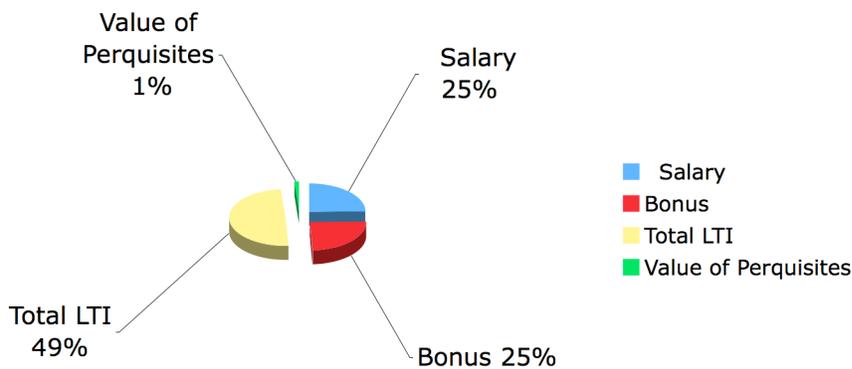
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company chooses to position it. Too little compensation affects the company's ability to attract and retain talent, too much affects its competitiveness (in either real or perceived terms). Companies may want to consider using pie charts to illustrate the relative value of one element of compensation to another at target as compared to market (about 2/3 of the companies in the initial study added charts, tables and graphs to enhance their presentations). If you take this approach, consider one set of charts for the CEO position (see below) and another set of charts for the NEOs combined.

CEO Current Compensation Mix Targeted at 100% of Market



CEO Fortune 100 Compensation Mix





Regarding how one element affects another, sometimes the relationship is clear-cut and sometimes it is not. For example, base salary typically serves as the foundation for determining annual and long-term incentive plan amounts (i.e. as a percentage or multiple of salary); however, once the targeted amount has been determined the actual amount paid is often decided based on performance (corporate or individual), incumbent potential and/or discretion. Another example of how some compensation elements influence others is a company that has chosen to position base salary slightly below market while targeting annual and long-term incentives above market. Although total compensation was targeted above market, it was positioned in such a way as to have more pay at risk.

Some elements of compensation have a minimal relation to each other, as is the situation with health, welfare and retirement benefits and perks. For instance, health care benefits are usually positioned solely on market norms (seldom will you find a company targeting benefits significantly above or below market). The typical relationship between salary and health and welfare benefits is that the former drives the value of short and long term disability and regular and supplemental term life insurance. Perks or fringe benefits may be determined by industry norm and position levels and may not have any relationship to other compensation elements. For example, the author knows of one retail company which offered financial counseling to its executive officers to assist in maximizing the value of the company's compensation offering while alleviating some of the pressure on their NEOs to make financial decisions without expert guidance.

External Benchmarking of Compensation – The SEC has asked some companies to provide a more detailed explanation of *how they used comparative compensation information and how that comparison affected compensation decisions*. Key questions to address regarding benchmarking include the following.

- a) Which elements of compensation were benchmarked?
- b) What source or sources were used (comparator groups, published or custom surveys)?
- c) If the benchmarking source varied by compensation element, what were the differences in the sources used?
- d) If benchmarking was completed using a comparator group, which companies were included in the group and what industries did they represent?
- e) If the company set its executive compensation targets or maximum award levels in relation to specific market percentiles, which percentiles were identified (by element and performance level if applicable)?
- f) If the company benchmarked its executive compensation but retained discretion to determine a different point or range to set pay from, what was the nature and extent of that discretion and how was it exercised?

Use of Tally Sheets - The SEC has asked companies that utilized tally sheets to disclose in greater detail *what information was presented and how it was used to make compensation decisions*. Tally sheets are used to quantify the various elements of compensation and the value of total reward (or severance) package. This information can then be compared to compensation levels in the marketplace. If your company used tally sheets to help determine executive compensation, you need to disclose what information was presented, how it was analyzed and how it influenced pay decisions. (3C supports the use of tally sheets to make compensation decisions and also recommends that you consider how they can be used to enhance your CD&A



presentation. An example is provided in the last section of this document.)

Internal Equity – The SEC has asked some companies *how internal equity considerations influenced compensation decisions*. For example, the author knows of one company that paid all NEOs proportionately the same below target bonus amount regardless of individual performance since the company did not meet its financial targets. If internal equity did play into your company's actual compensation decisions, you need to discuss how.

Allocating Different Forms and Amounts of LTIs – Some companies were asked by the SEC to clarify *why LTI awards were made in the forms and amounts decided*. For example, one company chose to award recipients stock options and SARs based on a 3-to-1 ratio because it considered the trade off appropriate given the present value of the stock option vs. the stock price. Another company allocated stock options and performance-based restricted stock units to recipients on a 50/50 basis because it wanted to balance a higher-risk award with a lower risk one. Why one approach is utilized versus another may be based on the company's compensation philosophy and objectives, market practices or more. Whatever the reasons were, they need to be disclosed.

Differences in NEO Compensation - The SEC has asked companies to disclose *whether there are material differences in policies and compensation between the NEOs*. For example, in most companies the salary, annual and long-term incentive opportunities and actual awards are higher for the CEO as compared to other NEOs. Why the CEO earns more compensation than other NEOs plus any material distinctions in NEO compensation below the CEO level needs to be discussed.

Performance Targets – More than any other question, the SEC asked companies to *disclose performance goals when they are material to understanding executive compensation policies or decisions for the last fiscal year*. Appropriate items for disclosure include the following.

- a) Descriptions of performance measures used,
- b) Performance targets and actual results including whether any financial data was excluded from the final accounting (i.e. an unplanned acquisition or divesture),
- c) Qualitative inputs regarding performance,
- d) Individual performance goals (discussed in more depth later), and
- e) Calculation of non-GAAP financial amounts.

An important issue for many companies regarding performance targets is the potential for adverse effect or competitive harm caused by revealing this information. This concern is understandable given the sensitive nature of key financial and operational measures typically found in compensation plans. The SEC does allow companies to request *confidential treatment of performance targets*³ under Rule 83; however, it's unclear at this time how accepting the SEC

³ SEC Rule 200.83 governs the procedure under which companies can request confidential treatment of performance goals contained in a response letter or for supplemental information provided to the SEC. Confidential treatment should be requested in writing at the time the information is provided to the SEC.



will be of these explanations. (This does not mean you should not try if you think you have a valid argument.)

If you believe your company would be adversely affected by revealing performance targets, you should disclose the following in its place.

- a) Which performance measures were used by plan (include descriptions of the measures and whether any results were excluded in the final accounting),
- b) How difficult the performance goals were to achieve (in light of past performance),
- c) What the likelihood was of the goals being achieved, and
- d) How the achievement of goals affected award decisions.

It should also be noted that the SEC has asked some companies that used the above approach to *provide more specific disclosure to help investors understand the difficulty in achieving or likelihood of achieving various performance measures*. Minimally this may require that a company discuss how it determined degree of difficulty or likelihood of achievement.

Individual Performance – As mentioned in the section above, the SEC wants companies to *disclose how individual performance influenced compensation decisions*. If individual performance did factor into your award decisions, you need to disclose the following by element.

- a) How was individual performance analyzed (achievement of goals, contributions to business performance, qualitative inputs, etc.)?
- b) How much influence did individual performance have in determining the final award amounts?

A related issue is whether individual performance targets and actual results need to be disclosed. For reasons similar to the ones stated above, most companies are uncomfortable disclosing this information. If this becomes an issue with the SEC, some compensation experts predict that it will influence companies to move away from individual performance goals and fall back on company financial goals to determine performance-based awards.

Actual Award Parameters – The SEC has also asked companies to elaborate to *what extent actual compensation was either inside or outside of targeted parameters*. Award parameters can be identified in relation to threshold, targeted or maximum amounts and furthered compared to market percentiles of comparator groups (if your company chose to benchmark compensation in this fashion). See the table below for an example.

	Award Threshold	Actual Award	At Budget	Maximum Award
% of Target Bonus Earned	50%	95%	100%	150%
Market Percentile Targeted/Actual	25th	48th	50th	75th



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Rationale Used to Determine Awards – Very importantly, the SEC wants companies to address *how actual levels of compensation were decided*. Since many factors impact compensation decisions, it is best to disclose your company's rationale by element of compensation and by NEO when individuals have been treated differently. Some key determinants of actual compensation awards to consider include the following.

- a) Performance as measured against pre-established goals (company - individual),
- b) Formulas such as those typically found in incentive plans,
- c) Guidelines such as average projected salary increases,
- d) Benchmark data, and
- e) Discretion applied by the Committee or CEO (i.e. for other NEOs).

Another dimension of this question is how much did one factor or another influence a compensation decision. For example, the CEO recommends to the Committee a large (20%) increase for a NEO reporting to him/her. The rationale behind this recommendation could include the following.

- Overall individual performance, which included significant contributions made to the business by the executive,
- Average projected increases for executives for the year,
- Prior year increase for this individual,
- Potential for advancement, and
- Benchmark data, which indicated the executive was paid significantly below market for the position he/she held.

In this example the significant determinants of the actual base salary increase for this executive were overall individual performance and the benchmark pay data.

Another example is annual incentive award paid to the NEOs in varying amounts from target to 80% of maximum award. The drivers of these awards include the following.

- Company financial performance, which established the bonus pool,
- An incentive award formula, which allocated ½ of the award based on executive team performance and ½ of the award based on individual performance, and
- Individual performance as measured by overall performance rating, which was assessed based on individual performance goal achievement and adherence to and living company values.

The Role of Advisors and Consultants – The SEC has asked companies to disclose *the nature and scope of all advisory or consulting arrangements related to executive compensation*. Of particular interest to the SEC is the following.

- a) The role of advisors or consultants in executive compensation (i.e. do they determine or recommend amounts or forms of compensation?),
- b) Whom they report to, and
- c) Whether the consultant or his/her firm performs other work for the company.



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Given the heightened scrutiny of compensation decisions, many Board Committees have decided to retain their own consultants to advise them on executive compensation matters. Examples of some of the roles an executive consultant retained by the Committee may perform include the following.

- Advise the Committee of the appropriateness of any executive compensation action(s) it is considering.
- Keep the Committee abreast of market norms and trends.
- Advise the Committee of rules and regulations affecting executive compensation.
- Compile and analyze benchmark compensation data for executive positions.

If your company uses the same executive consultant to advise the Committee and Management, you should consider providing an explanation of this relationship.

Role of the CEO in Making Compensation Decisions – Where it was not clearly stated, the SEC has asked some companies to explain the role of the CEO in executive compensation. This may involve expressing opinions to the Committee regarding the effectiveness of the executive compensation program, advocating changes to the program or recommending various NEO pay actions.

Recovery of Awards – The SEC has asked some companies, which based some elements of compensation entirely on company financial performance, to disclose *what their company policy is for recovery of awards* (presumably when financial results have to be restated or some other reporting irregularity has occurred). This question has caused some companies to institute “claw back” provisions that require executives to return compensation if it was obtained in a fraudulent manner. If your company does not have such a policy, it should consider adopting one.

Employment, Severance and Change-in-Control (CIC) Arrangements – Another area of disclosure that has attracted the attention of the SEC are *employment, severance and change-in-control agreements*. Aspects of these agreements that the SEC has asked companies to expand upon where disclosure was incomplete include the following.

- a) Terms of the agreement,
- b) How the various provisions of the agreement including compensation levels were decided and why (this includes why different amounts were identified for different triggering events),
- c) How the agreement supports the company’s overall compensation objectives, and
- d) Whether the agreement affects decisions regarding other compensation elements.

Explanations regarding why a company targeted the levels of compensation it did need to be expanded beyond “this is the prevailing market practice”. Tally sheets, like the one outlined on the next page, are ideal for highlighting the components of these agreements under different triggering events. Also, some companies may need to divulge how their stock-based incentive plans operate when certain triggering events affect awards under the plan.



Example - Change-in-Control Agreement				
Compensation Element	Involuntary Termination w/o Good Reason or Voluntary w/ Good Reason	Voluntary Termination w/o Good Reason	Termination for Cause	Death or Disability
Salary				
Annual Incentive				
Long-term Incentive				
Stock Options				
Health & Welfare Benefits				
Qualified Retirement Plan				
Non-Qualified Plan				
Perquisites				

Director Compensation – The SEC has also asked some companies *why there are differences in compensation between Directors, and how (equity) grant dates are determined for Directors.* Material differences in compensation among Directors typically exist because of differences in roles and responsibilities, as in the case of a Lead Director or committee chairs. How grant dates are decided and the fair market value(s) of awards should be disclosed in the same fashion as management equity awards.

In closing, it is important that companies start analyzing their CD&A in light of the SEC’s comments and consider how their disclosure should be modified or enhanced for this next reporting cycle. Companies should also continue to reassess their existing compensation plans and practices in light of the new disclosure rules and consider whether changes should be made in support of shareholder interests.

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