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The Push for Clarity: Proposed SEC Rules on Proxy Statement Disclosure

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Introduction

The Securities and Exchange Commission's comprehensive new proposals for disclosure of executive compensation in the proxy statement of U.S. public companies respond to 14 years of developments in executive compensation since the last major SEC overhaul in 1992. Currently, the federal securities laws require clear, concise, and understandable disclosure about the amount and type of total compensation paid to chief executive officers and other highly compensated executives of public companies. In recent years, increasing widespread interest in executive pay and the perceived inadequacy of current disclosure spawned frequent front-page headlines and heated rhetoric from members of Congress and shareholder advocates.

The proposed rules cover issues relating to disclosure of not only executive and director compensation but also related party transactions and corporate governance, as well as certain disclosures required by Form 8-K. While nothing in the proposed rules mandates specific changes in executive pay, it appears that the SEC's goal is to encourage companies to look at total compensation and actually take action if the compensation appears to be ineffective or inappropriate.

New rules will likely not be effective until the 2007 proxy season. The SEC's comment period on the new rules ended on April 10, 2006. The Commission will likely spend several months deliberating and responding to the extensive comments submitted on the new rules.

This article identifies the purpose and goal of the proposed rules, provides an executive summary of the key provisions, offers general observations about the proposed rules, and suggests a list of action items for compensation committees as they begin to prepare for the implementation of the new guidelines.

The Goal and Rationale of the Proposed Rules

The current SEC proxy disclosure rules were formulated in 1992. Since then, there have been significant changes in executive compensation techniques and strategies; however, the current disclosure system has not been amended to keep pace with these changes. For example, the adoption of the Financial Accounting Standards Board Statement FAS 123R, *Share-based Payment*, has created a shift away from service-based stock option grants in favor of performance-oriented, long-term incentive grants. Since performance-oriented awards were not common in 1992, due to the adverse accounting treatment at the time, the current disclosure rules do not require particularly detailed information regarding them.

However, the proposed rules are meant to do more than simply address a few changes in pay trends; rather, they are meant to give the average investor a clearer view of a company's policies, practices, and decision-making

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processes with regard to compensation. More than 50 percent of Americans own stock. For many of these shareholders, compensation serves as a window to assess management's values and beliefs. These shareholders have long complained about the lack of clear and transparent disclosure as it pertains to executive pay. The current disclosure rules do not allow a common shareholder to assess the total compensation cost of an executive as it is difficult to value various executive benefits and long-term incentive plans. The proposed rules seek to require companies to divulge significantly more information about the total compensation, retirement benefits, and perquisites of each of the company's five highest-paid executives.

It is important to understand that the goal of the new rules is not to curtail or rein in executive pay. Simply put, it is not the government's job to address the appropriateness of pay levels but it is, however, the government's job to be a governor and ask for transparency so that the market has the relevant information to address the issue of executive compensation.

Executive Summary of the Proposed Rules

The stated goal of SEC's proposed proxy disclosure rules for executive and director compensation is to provide investors with a more complete picture of total compensation earned by a firm's chief executive officer (CEO), chief financial officer (CFO), and three other highest paid employees as calculated in the expanded Summary Compensation Table (SCT) or tally sheet. Moreover, the SEC intends for the new rules to provide better information about key financial relationships among registrants and their executive officers, directors, significant shareholders and these individuals' respective immediate family members. The proposals rely heavily on the increased use of tabular disclosure of financial and statistical information, as well as an enhanced requirement for narrative descriptions of critical elements. Additionally, the rules would require SEC filings such as Form 10-Ks and proxy statements to include "plain English" narratives or tabular compensation information. The key provisions of the proposed rules include:

- × **Compensation Discussion and Analysis:** A new Compensation Discussion and Analysis (CD&A) section (which is intended to be similar to the Management's Discussion and Analysis section accompanying financial statements) will replace the current compensation committee report and stock performance graph. The new CD&A will require significant new disclosures regarding compensation objectives and policies, and the process through which the company implements its executive compensation.
- × **Summary Compensation Table:** A reorganized Summary Compensation Table, which redefines the concept of "total compensation," will include the dollar value of all compensation earned during the last three fiscal years, whether paid currently or deferred, including the value of current earnings on outstanding awards. Disclosing the value of each type of compensation will facilitate providing total value of compensation for the Total Compensation column required by the proposed rules. In general total compensation will mean **base salary + annual cash incentive (bonus) + grant date value of equity awards + amounts earned under nonstock incentive plans + all earnings on outstanding stock and nonstock incentive plans + value of perquisites + earnings on nonqualified deferred compensation, tax gross ups, and increases in retirement benefits.** As modified, the SCT would include, from left to right, columns on Total Compensation, Salary, Bonus, Stock Awards, Option Awards, Non-Stock Incentive Plan Compensation, and All Other Compensation ("Exhibit A").
- × **Covered Executives:** The methodology for determining named executive officers in the proxy will change. In addition to the CEO, the executive officers named in the Summary Compensation Table will include the CFO, regardless of compensation. The three other most highly compensated executives will be determined based on their total compensation as disclosed in the expanded Summary Compensation Table, rather than on the sum of salary and bonus as under the current rules.
- × **Equity Tables:** Two supplemental equity grant tables will be required to increase disclosure of performance-based and nonperformance-based equity and cash incentive awards (time-vested options are deemed nonperformance-based), the value of all outstanding awards, and the amounts realized through vesting or exercise during the year ("Exhibit B and C").

- × **Post-Employment and Change-in-Control Benefits:** Retirement, post-employment, and change-in-control benefit estimates will also need to be disclosed. Proposed new tables and narrative disclosure requirements would require disclosing estimates of annual retirement benefits and estimates (not merely a description) of amounts payable upon termination of employment and/or upon a change in control (including disclosure of the material assumptions underlying those estimates) (“Exhibit D”).
- × **Narrative Disclosures:** Narrative disclosures, following the Summary Compensation Table and the proposed supplemental tables, will focus on the quantitative disclosures in the tables. This disclosure would describe any additional material factors necessary to understand the information disclosed in the tables, and may include, among others things, descriptions of material terms of employment contracts, award terms relating to data provided in the SCT and supplemental tables, and information regarding retirement benefit plans such as the material plan assumptions underlying an increase in actuarial value of retirement plans.

Additionally, in a move intended to elicit disclosure about highly compensated employees who are not executive officers of the company, the proposals would require companies to provide, as part of their supplemental narrative disclosure, pay information for up to three additional employees who are not executive officers if their total compensation for the last fiscal year exceeded that of any individual Named Executive Officer (“NEO”). While these employees would not have to be identified by name, companies would be required to disclose each individual's total compensation and describe their job.

- × **Compensation-Related Form 8-K Amendments:** Proposed changes would narrow the group of executive officers for which new or amended compensatory arrangements would trigger a Form 8-K filing and narrow the requirement to file a Form 8-K with respect to director compensation.
- × **Related Person Transactions:** Proposed changes would include a disclosure requirement regarding policies and procedures for approving related person transactions and increase the threshold for disclosure from \$60,000 to \$120,000.
- × **Director Independence:** Proposed changes would require disclosing the identity of independent directors as well as any relationships or transactions not otherwise disclosed that were considered by the board of directors when determining that a director was independent.
- × **Compensation Committee Process and Procedures:** Proposed changes would require a discussion of compensation committee procedures, including the roles of executive officers and compensation consultants in making recommendations regarding compensation matters.
- × **All Compensation, Beneficial Ownership, Related Transaction and Corporate Governance Disclosure Required in Plain English.** The proposed rules will require companies to draft disclosures of all executive and director compensation, beneficial ownership, related transaction and corporate governance in plain English, using the principles that currently apply only to a prospectus.

General Observations of the Proposed Rules

The proposed rules are a watershed event in the world of executive compensation and corporate governance. As SEC Chairman Cox stated in his introductory remarks at the SEC meeting on Jan. 17, 2006, at which the Commission approved proceeding with the rules by a unanimous vote, the purpose of the proposal is “wage clarity not wage controls” (i.e., improving the clarity of compensation disclosure, not imposing limits on the compensation of top executives). By improving disclosure, the SEC believes that shareholders, as well as the compensation committee and board of directors of public companies, will be in a better position to assess the compensation provided and formulate decisions on its appropriateness.

While we are strongly supportive of the goal to provide investors with a clearer and more complete picture of executive and director compensation and the process in making pay determinations, there is a real possibility that some of the recommended disclosures will actually lead to more confusion. In some cases, the enormous level of

detail to be disclosed may be disproportionate to the benefit that will actually be realized.

We offer the following general observations on the proposed rules:

- × The composition process of a thorough CD&A will require immense effort and cooperation between management (specifically HR and Finance), the compensation committee, and the Committee's advisors. Interestingly, the CD&A will be subject to the same liability provisions of the Exchange Act and to the certification requirements of Sarbanes-Oxley. In other words, the CEO and CFO would be required to certify a process that includes decisions about their own pay. Some may argue that the CEO and CFO should be divorced from certifying the CD&A for independence and governance reasons. Given that many compensation committees tend to meet in executive session without management, it is difficult to ask management to certify a document that contains decisions with which they were not directly involved.
- × The focus on total compensation is appropriate in principle. However, this principle will be challenging in special instances such as large one-time incentive grants or severance payments or vesting of large retirement benefits made to senior executives. In these cases, senior executives who are typically not NEOs, will appear in the proxy statement and it is likely that NEOs will change on an annual basis for many companies.
- × The “All Other Compensation” column will be the most challenging portion of the SCT. Companies will need to make a significant number of assumptions to compute the annual increase in actuarial value for defined benefit pensions, including supplemental executive plans. The assumptions will make these disclosures both complex and subject to many interpretive issues. More than any other, this column will garner great scrutiny because of the increased visibility of hidden compensation items such as perquisites and earnings on nonqualified deferred compensation plans.
- × The change-in-control calculations will be highly speculative. Questions such as when will a transaction occur; at what price; who will be CEO at that time; what will the CEO's base amount; and how many unvested options and restricted stock will be accelerated will need to be addressed and answered within reason. The outcome of these questions may be that two companies with identical policies may have vastly different results.
- × It is possible that many NEOs will be highly uncomfortable regarding the aggregate disclosure of deferred compensation arrangements given their belief that this information is private and confidential.

Implications for 2007 Disclosure

Even though the proposed rules will not be in effect until the 2007 proxy season, compensation committees and boards need to be mindful of how the current compensation structure impacts future disclosure of executive and board pay. In order to prepare for the 2007 proxy disclosure guidelines, we suggest the following action steps for compensation committees:

- × **Review Current Compensation Decisions—Take the Proposed Changes Into Account Now:** Although final rules adopted by the SEC could vary in any number of ways from the proposed amendments, it is apparent that the SEC will significantly expand the current executive compensation disclosure requirements and that the new and expanded disclosures will apply to 2006 compensation. Accordingly, as companies—and compensation committees of boards of directors—consider compensation matters relating to the current year and beyond, it is imperative that they consider how those decisions will be disclosed under the proposed amendments.
- × **Examine Your Executive Compensation Exposure:** Companies should assess the total compensation cost of each of the potential proxy-named executives by way of tally sheets. By compiling and reviewing tally sheets, a company will be able to take inventory of all potential compensation paid to executives under the current executive compensation programs. A tally sheet for the top 10-15 executives will help prepare the compensation committee for any potential surprises or “excessive pay” issues in 2007.

× **Valuation Methods and Assumptions:** Companies should begin to determine appropriate valuation methods for equity incentives, nonqualified deferred compensation, retirement benefits and perquisites. Additionally, companies need to determine the appropriate assumptions for severance and change-in-control calculations. These assumptions and encompassing calculations are complex, time consuming and require significant foresight. As such, companies will need to model several scenarios and determine the appropriate scenario for proxy disclosure.

× **Take a “Fresh Look”—Review Plans, Policies, and Practices:** As discussed, the proposed amendments would require significantly expanded disclosure concerning the goals of compensation programs, how different elements of compensation programs are designed to achieve those goals, how decisions regarding different compensation elements are made, and how different elements of compensation work together and impact decision making regarding other components of compensation. Companies should consider taking a “fresh look” at their entire executive and director compensation programs—for instance by taking into account what potential disclosure under the proposed amendments might look like—to ensure that the various elements of compensation work in the manner intended.

× **2006 Proxy Statements—Compliance Implications (*for those who have not filed yet*):** Some companies are currently drafting proxy statements for use at their 2006 annual meetings. In light of the proposed changes, as well as calls from institutional investors and other organizations for greater transparency in executive compensation disclosure, companies should consider to what extent, if any, they want to include expanded disclosure regarding executive and director compensation in their 2006 proxy statements.

For companies that have sizable perquisites, it may helpful to review the new SEC guidance regarding what constitutes a perquisite. To the extent such guidance is currently applicable; companies should review and, if necessary, consider expanding their current disclosure of perquisites in light of this guidance.

For companies that have already filed their proxy statement, it may be helpful to draft a mock CD&A and have HR and Finance begin determining total compensation for each of the top 10-15 highest paid executives.

× **Focus on Quality Not Quantity:** Compensation committees need to remember that the quality of the disclosure is more important the quantity of data and narrative that will be in the statement. Companies should remember to use “plain English” as a narrative with the assistance of charts and bullet points.

× **Begin Preparing NOW!**

Final Thoughts

The proposed rules will address three main problems with the current disclosure: transparency, board accountability, and shareholder oversight. The rules will allow shareholders to decipher how much total compensation was earned, what were the components of pay, and what were the performance and incentive targets. Given this information, results of operations, and stock returns of a company, shareholders will be able to assess if they received a reasonable “return on compensation” paid to the executives. As such, if executive pay goes up with or without acceptable returns, then the board or compensation committee will be held accountable for such results.

Boards and compensation committees should continue to monitor these proposed rules and consider their implications in establishing and modifying executive compensation plans. Compensation plans should reflect the business objectives of the enterprise, and boards should be mindful of the goals of the disclosure requirements. Even before these proposals become final, they provide a valuable insight to the importance that the SEC places on compensation disclosures and companies should re-evaluate their executive compensation disclosure in their proxy and Form 8-K filings to provide stockholders with comprehensive, transparent explanations of the goals and specific details of the company's compensation plans.

History should provide some guidance on the future implications of these proposed rules on disclosure. For example, after adoption of §162(m) of the tax code, which allowed stock options to be exempt from the million dollar

deduction limit, stock option grants exploded across all industries. More recently, after the announcement and implementation of FAS 123R, stock options grants have declined in favor of performance-based long-term incentives and restricted stock. While it is difficult to make any assumptions on how these rules will impact executive pay levels, it is safe to assume that, if passed, these rules will provide shareholders with greater clarity and rationale for most compensation decisions made by management and compensation committees.

Exhibits

Exhibit A

SUMMARY COMPENSATION TABLE

Name and Principal Position	Year	Total (\$)	Salary (\$)	Bonus (\$)	Stock Awards (\$)	Option Awards (\$)	Non-stock Incentive Plan Compensation (\$)	All Other Compensation (\$)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)
PEO	_____							

PFO	_____							

A	_____							

B	_____							

C	_____							

Exhibit B

GRANTS OF PERFORMANCE-BASED AWARDS

Name	Performance based stock and stock based incentive plans: number of shares, units or other rights (#)	Performance based options: number of securities underlying options (#)	Non-stock incentive plan awards: number of units or other rights (#)	Dollar amount of consideration paid for award, if any (\$)	Grant date for stock or option awards	Performance or other period until vesting or payout and option expiration date	Estimated future payouts		
							Threshold (\$ or #)	Target (\$ or #)	Maximum (\$) or (#)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)	(i)	(j)
PEO									
PFO									
A									
B									
C									

Exhibit C

GRANTS OF ALL OTHER EQUITY AWARDS

Name	Number of securities underlying options granted (#)	Exercise or base price (\$/Sh)	Expiration date	Number of shares of stock or units granted (#)	Vesting date	Grant date
(a)	(b)	(c)	(d)	(e)	(f)	(g)
PEO						
PFO						
A						
B						
C						

Exhibit D

RETIREMENT PLAN POTENTIAL ANNUAL PAYMENTS AND BENEFITS

Name	Plan name	Number of years credited service (#)	Normal retirement age (#)	Estimated normal retirement annual benefit (\$)	Early retirement age (#)	Estimated early retirement annual benefit (\$)
(a)	(b)	(c)	(d)	(e)	(f)	(g)
PEO						
PFO						
A						
B						
C						