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A Call for Transparency

The SEC proposes sweeping compensation disclosure reforms.

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Director Summary >

Responding to shareholders' criticism of inadequate and confusing executive pay information, the **Securities and Exchange Commission (SEC)** has proposed sweeping changes to its executive compensation disclosure rules (<http://sec.gov/news/press/2006-10.htm>). **The proposals would require companies to provide a total compensation figure for top executives, as well as a new report discussing how their executive compensation programs are structured and implemented.**

The proposals would require far more information about equity awards for top executives, retirement and severance benefits, and perquisites—and even tabular disclosure of director pay.

Now, corporate directors need to assess how these proposals will impact their companies. Regardless of whether they are adopted, these

proposed rules will surely set an immediate “best practice” standard.

Some of the proposals, such as the enhanced disclosure of executive retirement benefits and severance and change-in-control payments, are likely to be quite controversial, and may change before final adoption. The Commission is soliciting public comments on the proposals until the end of March, and hopes to adopt final rules later this year. If the SEC meets this timetable, the new rules should be in place in time for the 2007 proxy season.

A Fresh Look at Disclosure

While the SEC has made minor enhancements to the disclosure rules since its last major update in 1992, most observers believe that the quality of the executive pay disclosure in corporate proxy statements has stagnated in recent

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National Association of Corporate Directors (NACD), an independent not-for-profit organization founded in 1977, is the country's only membership organization devoted exclusively to improving corporate board performance. The NACD conducts educational programs and standard-setting research, and provides information and guidance on a variety of board governance issues and practices. Membership comprises board members from U.S. and overseas companies ranging from large publicly held corporations to small over-the-counter, closely held, and private firms. NACD lists all interested members on The Director's Registry, which is used by member companies and others that seek qualified directors. With chapters in many major cities providing educational programs and networking opportunities, NACD operates at both a national and local level. To educate the corporate community and to provide networking links among NACD members, the NACD holds an annual Corporate Governance Conference, where it presents a Director of the Year Award.



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years. Thus, SEC chairman **Christopher Cox** has made improved executive compensation disclosure a priority since joining the Commission last summer. This has led to the current proposals, which tackle many issues that have been of concern to institutional shareholders. In particular, shareholders have complained that the “Summary Compensation Table” no longer provides the full picture of the total pay packages of a company’s senior executives because of the proliferation of executive benefits and various equity vehicles. As a result, they have been clamoring for companies to disclose a total compensation figure that incorporates all executive compensation, not just annual pay and long-term incentives.

The proposals address this issue by making three fundamental changes to the Summary Compensation Table, in addition to other proposed changes:

Total pay. Responding to shareholder demands for a “bottom line,” the proposals would require companies to add up the amounts reflected in the Summary Compensation Table to produce a total compensation figure for each named executive officer for each of the three years covered by the table. This figure would be disclosed in a new “Total Compensation” column at the start of the table.

Fair value. Because the disclosure rules have not kept pace with either market practice or shareholder demands for information about equity awards, the proposals would require companies to disclose the grant-date fair value of all stock-based awards, including stock options, granted to the named executive officers in the Summary Compensation Table (rather than just the number of shares subject to options and the dollar value of restricted stock awards, as currently required).

Other pay. The proposals would require that the current “Other Annual Compensation” column be merged into the “All Other Compensation” column in the Summary Compensation Table, which picks up any item not otherwise required to be disclosed in another column, including perquisites, company contributions to defined contribution retirement plans, and the aggregate increase in the actuarial value of pension plans accrued during the year and all earnings on nonqualified deferred compensation.

The proposals would further require that the Summary Compensation Table be supplemented by two separate equity award tables—one covering performance-based awards and the other grants of all other (service-based) equity awards.

The New Compensation Committee Report—Beyond the Boilerplate

For a decade and a half, shareholders have had only the “Board Compensation Committee Report” (mandated in 1992) to fathom the company’s compensation policies, including the basis for the compensation paid to the company’s executives and the basis for the CEO’s compensation for the last fiscal year. Over the years, however, the quality of these reports has deteriorated, with the SEC regularly reminding companies that “boilerplate” discussions are not acceptable. The proposals address this concern by replacing the Board Compensation Committee Report and the “Performance Graph” with a new “Compensation Discussion and Analysis” (CD&A), modeled after Management’s Discussion and Analysis of Financial Condition and Results of Operations (MD&A) currently required for more general disclosures. The MD&A—while it can contain boilerplate—is generally considered to be helpful to investors in analyzing company performance.

The CD&A would require narrative disclosure of a company’s policies and decisions involving the compensation of the named executive officers. It also would be expected to provide specific details about how the pay program relates to corporate performance. Finally, it would have to address the compensation-setting process, such as whether the committee considered all elements of the CEO’s compensation in making individual pay decisions and what tools the committee used in making its decision.

In explaining these elements at an open meeting of the Commission on January 17, 2006, SEC staff summarized the questions as follows:

- What are the objectives of the pay plan?
- What are the elements in the pay plan?
- Why were the elements used?
- How did the committee determine the amount?
- How does the pay fit into company objectives?

These new requirements would force companies to take a fresh look at their compensation programs and how they operate. [Ed note: For general guidance on compensation philosophy along these same lines, see the *Report of the NACD Blue Ribbon Commission on Executive Compensation*, NACD, 2002. <https://secure.nacdonline.org/source/library/ordershome.cfm?activeSection=Orders>]

Summary of Proposed Disclosure Changes

Topic	Current Requirement	Proposed Requirement
Executives covered	CEO plus four highest paid senior executives.	CEO and CFO plus three highest paid senior executives.
Total compensation	No total figure required in Summary Compensation Table.	Total compensation figure for executive compensation included in Summary Compensation Table.
Stock options	Number of shares subject to options included in Summary Compensation Table.	Grant date fair value of stock options included in Summary Compensation Table.
Compensation committee report	Explain goals and objectives behind executive compensation and factors used in determining specific awards.	Replaced with Compensation Discussion and Analysis explaining objectives and implementation of compensation program.
Perquisites	Total aggregate value of perquisites above \$50,000 or 10 percent of total annual salary and bonus, if less for each named executive.	Total aggregate value of perquisites above \$10,000 for each named executive.
Severance payments	Description of payments in excess of \$100,000 on a change in control for each named executive.	Value of payments and benefits (including perquisites) to be made on termination or change in control for each named executive.
Retirement plans	General table of benefits payable for different levels of compensation and years of service.	Retirement plan disclosure table, including potential annual benefits payable to each named executive.
Director compensation	General description of amounts paid for board service, committee participation, and special assignments.	Summary table of annual compensation for each director, with supplemental narrative disclosure.

Tracking the Life Cycle of Equity Awards

To keep shareholders informed about the status of equity awards following their grant, the proposals would require companies to provide an “Outstanding Equity Awards at Fiscal Year-End Table,” which would show the unrealized appreciation that has accumulated in these awards during the time they have been held by the named executive officers. This table would be accompanied by an “Option Exercises and Stock Vested Table,” which would show the amount actually realized by a named executive officer when exercising a stock option or earning restricted stock.

Additional Retirement Pay Information

While the value of executive retirement benefit packages has increased in recent years, the disclosure about these arrangements has been difficult to read and understand. Under the proposals, companies would be required to provide an array of disclosures about retirement plans and post-retirement benefits:

- The proposals would require a new “Retirement Plan Potential Annual Payments and Benefits Table,” which would cover the estimated annual benefits payable to the named executive officers under a company’s tax-qualified defined benefit plans.
- The proposals would also require a new “Non-qualified Defined Contribution and Other Deferred Compensation Plans Table,” which would include executive and company contributions to such plans, and earnings

and withdrawals during the year, and provide year-end account balances.

- The proposals would require companies to quantify the potential payments and benefits (including perquisites) that would be received by each of the named executive officers under a number of termination of employment scenarios: retirement, voluntary termination, involuntary termination, and following a change in control of the company.

Companies will likely find these new disclosures to be challenging, particularly where the required quantification involves formulating assumptions involving future pay levels, tax rates, and other variables. And companies are likely to be troubled by how the total compensation figure will be used, particularly since the amount eventually received by the named executive officer may be significantly different from the disclosed amount.

Perquisites

The proposals would bring some long-overdue clarity to the disclosure of executive perquisites and other personal benefits. Most significantly, the proposals include interpretive guidance to assist companies in determining whether an item constitutes a disclosable perquisite and how to calculate the item’s value. In addition, the minimum disclosure threshold for perquisites would be decreased from \$50,000 (or 10 percent of reported annual salary and bonus, if less) to \$10,000.

Other Important Changes

The proposals include a few other changes that are noteworthy. Significantly, the CFO would automatically be a named executive officer for whom disclosure would be required regardless of the level of his or her compensation. Even with this change, the named executive group will remain at five: the CEO, CFO, and the three most highly compensated executives other than the CEO and CFO. And the proposals would require disclosure of the pay of up to three non-executives if their total compensation exceeds that of the named executive officers.

The requirements governing the disclosure of related-party transaction information would be updated and clarified under the proposals. The primary changes would involve the disclosure of policies and procedures for approving related-party transactions and an increase in the disclosure threshold from \$60,000 to \$120,000.

To make the disclosure more accessible to shareholders, the SEC is proposing to extend its “plain English” requirements for the organization, language, and design of information to the executive pay section of the proxy statement.

The proposals would clarify when executive pay decisions have to be reported on a “real time” basis on Form 8-K by narrowing the report’s focus to transactions involving named executive officers and consolidating all of the required disclosures about employment arrangements under a single heading. As a result, while companies will continue to be required to disclose significant pay decisions involving their senior executives as they happen, they will be able to defer disclosure of many routine executive compensation matters until their proxy statement.

Director Compensation Disclosure

In addition—and for the first time—tabular disclosure of director compensation would be required. Under the proposals, all aspects of director pay for the previous year would have to be disclosed, including retainers, meeting fees, special chair fees, equity or other long-term compensation, perquisites, and other payments. [Ed. Note: For general guidance on director compensation, see *Report of the NACD Blue Ribbon Commission on Director Compensation*, NACD, 2004. <https://secure.nacdonline.org/source/library/ordershome.cfm?activesection=Orders>]

Implications for 2006

Given shareholders’ sensitivity on executive compensation matters, companies will want to take a fresh look at their disclosure to see whether it satisfies the SEC’s current rules, as well as to identify areas where

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they can quickly and easily begin moving their disclosure towards the new system in preparation for the 2007 proxy season. We expect to see many “Total Compensation” disclosures in the current proxy season—even if the total doesn’t reflect all of the pay components that would be called for under the proposals.

Those companies that are out in front in adopting disclosure best practices, or those who need to improve their governance in response to shareholders’ concerns, will try to comply with at least some of the proposed changes even before they are adopted.

For example, many companies are already disclosing all of the perquisites given to senior executives. Some companies that are already disclosing more than is required may find early disclosure easy, but others that have taken a more conservative view of what they need to disclose may find this more difficult. In particular, it may be challenging for companies to anticipate how certain calculations—like the estimates of pension benefits—should be made in order to comply early.

If companies fear that the new rules would result in disclosure that could shock investors, they may decide to transition to the proposals incrementally during the 2006 and 2007 proxy season to lessen the impact. And it is possible that directors will rethink executive compensation decisions in 2006 to minimize fallout under an expanded disclosure environment. ■

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