THOUGHTFUL PAY ALERT

Compensia

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Enhancing Your 2009 Executive Compensation Disclosure

With the arrival of the new year, the 2009 proxy season is right around the corner. Even now, companies are beginning to draft their Compensation Discussion and Analyses and update their compensation tables for their next proxy statement.

These disclosures will be significant for several reasons. First, 2009 marks the first year that companies will be required to present three full years' data in their Summary Compensation Tables. Undoubtedly, compliance with this requirement will give rise to numerous technical issues concerning the completion of the table (particularly with respect to the footnotes and accompanying narrative disclosure), as well as potentially additional discussion in the CD&A.

Perhaps more importantly, however, this year's disclosure will be made in the midst of an ongoing and unprecedented economic crisis. Accordingly, companies will be faced with explaining how recent events have affected their executive compensation programs, particularly the effectiveness of their annual and long-term incentive plans and arrangements and the retentive value of their equity awards. In addition, the recently-enacted Emergency Economic Stabilization Act and accompanying regulations, including the Treasury Department's Troubled Assets Relief Program ("TARP"), have introduced new substantive executive

Our Tips for Better Disclosure in 2009

1. The key to an effective CD&A is explaining the reasoning behind your compensation policies and decisions.
2. Your incentive compensation arrangements should be the centerpiece of your CD&A; be sure to discuss in detail how they further your business objectives.
3. Given investor skepticism about the rigor of peer group selection, thoroughly and clearly explain how you chose your peer companies.
4. Incentive compensation arrangements can encourage risky behavior – be sure to discuss how you calibrate the risk/reward relationship.
5. Highlight your compensation recovery policy in your CD&A: who it covers, when it's triggered, and whether recovery is mandatory or discretionary.
6. When addressing post-employment compensation in the CD&A, focus on the purpose of your arrangements and how they fit into your overall executive compensation program.
7. When it comes to the tax deductibility of individual compensation elements, be specific about what was deductible (and what was not); avoid generalities.
8. Use a table to disclose and itemize executive perquisites; avoid the appearance of obfuscation.
9. Be sure to explain how you estimated the payment and benefit amounts potentially payable upon a termination of employment or a change in control of the company.
10. The Director Compensation Table is just like the Summary Compensation Table: be sure to supplement it with the details of how each compensation element works.

compensation standards which are likely to set the framework against which most executive compensation programs will be judged.

Finally, the SEC Staff is continuing to monitor compliance with the Commission's now-two and one-half year-old executive compensation disclosure rules and issue specific comments on companies' presentations. Based on recent comments from senior Commission officials, many companies continue to struggle with satisfying the Staff's expectations in several key areas – particularly the disclosure of incentive compensation arrangements.

With public interest in executive compensation at an all-time high, most observers expect that this year's disclosures will be scrutinized like never before. Consequently, you should assume that your 2009 disclosure will be thoroughly examined by your investors, the media, your employees, and regulators. With that in mind, we once again offer 10 tips to enhance the quality of your 2009 disclosure. These tips, which are based on our experience in advising numerous companies on preparing their executive compensation disclosure, as well as what we've learned from our interactions with the Staff, should help ensure that your executive pay disclosure is sound and effective in the current environment.

Once again, we've divided our tips between the Compensation Discussion and Analysis and the compensation tables. Unlike last year, these tips are weighted more heavily towards the CD&A in recognition of its preeminence in the disclosure framework and the importance of providing a comprehensive and transparent explanation of your compensation practices and decisions for the last completed fiscal year. As you will note, the suggestions involving the compensation tables continue to be oriented towards making the tables easier to navigate and read; always a challenge given the complexity of most executive compensation programs.

Enhancing Your Compensation Discussion and Analysis

1. Job One is Your Analysis

Even though we've now been through two rounds of CD&As, the SEC Staff has indicated that it is still not satisfied with the quality of the analysis that many companies are providing. While this isn't to say that there haven't been improvements in this area, in many cases the "how and the why" are still missing from the discussion. It's important to remember that the purpose of the CD&A is to explain the connection between a company's compensation philosophy and policies and the amounts presented in the compensation tables, not merely to describe the principal elements of the company's compensation program.

While there is no one "correct" approach, and the necessary analysis will depend upon the size of the company and the complexity of its compensation arrangements, a sound CD&A will address each material compensation element, describe how you arrived at the varying levels of compensation paid, and explain why your Board Compensation Committee believes that your compensation practices and decisions fit within their overall pay philosophy and objectives.

With this in mind, the Staff believes that the CD&A should:

- explain and place in context each of the specific factors considered when approving each material element of each named executive officers' compensation package;
- analyze the reasons why you believe that the amounts paid were appropriate in view of the various factors that were considered in making specific compensation decisions; and
- describe why or how (if applicable) determinations with respect to one element impacted other compensation.

We agree with these observations and recommend that you keep them in mind when drafting this year's CD&A.

2. Incentive Compensation is the Centerpiece of Your Disclosure

With incentive compensation (consisting of both cash and equity) making up the bulk of virtually every executive compensation package, it should come as no surprise that much of your CD&A should be devoted to explaining how your annual and long-term incentive compensation arrangements were designed and implemented. And, applying the principles-based disclosure requirements of the CD&A, in most cases, this will involve explaining how and why the associated performance metrics were selected and disclosing the target levels established for these metrics.

Here, we recommend avoiding the temptation to either claim "competitive harm" to shield this information from disclosure absent a legitimate (and reasoned) basis for your position or simply disgorging the details of these arrangements in a vacuum. When considering a competitive harm claim, you should assess the merits of your argument contemporaneously (and not at the time of a subsequent SEC Staff inquiry). Where you rely on the competitive harm exception, you also should expect that eventually your company will be called upon to justify any such assertion to the Staff. Consequently, a critical assessment of your position is more than just an academic exercise. Further, if you disclose this information, we recommend that you provide it within a framework that explains how your incentive pay arrangements further your company's business objectives. After all, unless this disclosure is presented in context, it may not be meaningful to most investors.

In our experience, when it comes to incentive compensation investors are primarily interested in two things: how much did you pay and how challenging were the target levels that were set for the associated performance metrics? We believe that if you keep these questions in mind when drafting this section of your CD&A, your presentation will be more robust and effective.

3. And Competitive Positioning Isn't Far Behind

A second key area to the SEC Staff (and investors) has been disclosure involving the competitive positioning of your executive compensation; particularly the role that "benchmarking" plays in setting or influencing pay levels. Where you benchmark a material compensation element, you are expected to identify the companies that comprise the peer group used for this purpose. More importantly, the Staff insists on meaningful disclosure on how the peer group was selected and the relationship between actual compensation and data used in the benchmarking study.

For many companies, this information will be critical to explaining how their executive compensation programs work and how their Board Compensation Committees reached specific pay decisions. Consequently, we recommend that you devote sufficient attention to this subject when drafting our CD&A. This summer, the Staff issued a helpful interpretation clarifying its position on what constitutes "benchmarking." This should eliminate many of the questions that arose last year as to when the specific identification of peer group companies is required. As for the basis for selection, more, rather than less, detail is warranted here. The prevailing concern of many investors is that peer group selection is not as rigorous as it should be. We believe that additional transparency here can overcome this suspicion and bolster the integrity of your competitive positioning analysis.

4. Excessive Risk – The Newest Compensation Issue

With the passage of the Emergency Economic Stabilization Act last fall, a number of substantive executive compensation standards were imposed on financial institutions participating in the TARP. Chief among these is the standard requiring these institutions to conduct an annual assessment of their incentive compensation arrangements to ensure that they do not encourage

their senior executives to take unnecessary and excessive risks that threaten the value of the institution, and to certify that they have undertaken this review.

While these standards are not applicable to entities that are not participating financial institutions, in view of the broader implications, we agree with the observations of John White, the former Director of the SEC's Division of Corporation Finance, that it would be prudent for Board Compensation Committees, when designing incentive compensation arrangements, to consider the particular risks that the company's executives might be motivated to take to meet the designated performance targets. Moreover, to the extent that these considerations form a material part of a company's compensation policies or decisions for the fiscal year, we believe that they should be addressed in the CD&A.

Since this "excessive risk" standard was only introduced in the past few months, many companies may conclude that this subject need not be addressed in their upcoming CD&A since they did not actively conduct a risk assessment in connection with their 2008 executive compensation program. However, given the significant attention that this subject has received, we believe that it may be worth discussing anyhow; if only to reassure investors that the company is monitoring its incentive arrangements for this issue.

5. Highlighting Your Compensation Recovery Policy

The new executive compensation standards for financial institutions participating in the TARP require them to implement a policy for the recovery of any bonus or incentive compensation paid to a senior executive officer if the payments were based on materially inaccurate financial statements and any other materially inaccurate performance metric criteria. This standard formalizes a practice that has become increasingly commonplace in recent years for many companies.

We expect that the prominence of this standard will focus investor attention on compensation recovery policies in 2009. While many companies have been describing their compensation recovery policies in their CD&As for several years, the practice is not yet universal. If your company hasn't been disclosing its policy, we recommend that you consider doing so in this year's CD&A. Even where you are describing your policy, we believe that it may be helpful to expand this description to discuss how and why your policy is appropriate in view of the structure and operation of your executive compensation program. This additional discussion may be particularly helpful where your policy is more limited than the scope of the new standard.

6. Post-Employment Compensation – Addressing the Right Issues

While most companies have devoted a significant portion of their CD&As to their post-employment compensation arrangements, specifically amounts potentially payable upon a termination of employment or a change-in-control of the company, many of these discussions overlook one or more of the central issues that should be covered in the CD&A when addressing these arrangements. We believe that your discussion should address each of the following items:

- The purpose of your severance and/or change-in-control arrangements;
- How these arrangements are structured and specific payout amounts or formula are determined; and
- The relationship (if any) between these arrangements and the company's overall compensation objectives, including how decisions about this element affect decisions made with regard to other compensation elements.

Remember that this discussion is supposed to analyze the reasons for offering these arrangements and how they align with your compensation philosophy and fit into your overall compensation program. The details of these arrangements and how they would operate under various scenarios should be part of your Poten-

tial Payments Upon Termination or Change-in-Control disclosure and not your CD&A.

7. Addressing the Deductibility of Your Executive Compensation

The new executive compensation standards for financial institutions participating in the TARP prohibit them from deducting any remuneration paid to their senior executive officers in excess of $500,000 per year. As with the standard involving compensation recovery policies, we expect that the prominence of this standard will focus investor attention on the deductibility of the compensation paid to executives at every public company in 2009.

While most companies address the deductibility of their executive compensation in their CD&As, frequently these discussions simply acknowledge the existence of a deduction cap, indicate that the company strives to ensure the deductibility of its pay, and reserves the right to pay non-deductible compensation if it is deemed to be in the best interests of the company and its shareholders. Given the attention generated by the standard, we believe that it may be prudent this year to confirm that each compensation element paid to the named executive officers is fully deductible by the company and, if this isn't the case. disclose that fact (including the amounts paid to each executive in excess of the cap) and explain why in their CD&A. While this hasn't been a very sensitive subject in the past, in view of the greater attention that compensation will receive this year, companies should consider actively managing expectations in this area or risk a potential backlash from investors.

Enhancing Your Compensation Tables

8. Pay Attention to Your Executive Perquisites

Although perquisites and other personal benefits comprise only a fraction of your executives' total compensation, investors (as well as key corporate governance watchdogs) consider them a key indicator of a company's executive compensation philosophy, as well as the attention that your Board Compensation Committee gives to compensation matters generally. As we recommended last year, your perquisites disclosure should be easy to locate and easier to understand. Typically, the most effective disclosures are presented in tabular – rather than narrative – form. Not only is a table easier for investors to find – and read, where your executives receive only nominal perquisites, this is immediately evident from a table – sending a powerful, and positive, message to your investors.

9. Pay Careful Attention to Your Termination and Change-in-Control Disclosure

Given the recent attention on "golden parachutes" and other severance arrangements, it is likely that your discussion of the severance and change-in-control arrangements for your named executive officers will be thoroughly scrutinized this year. Consequently, after the CD&A, this area deserves your considered attention in 2009. With this in mind, we recommend that you try to keep the descriptions of these arrangements as simple as possible. For example, instead of providing a detailed description of each arrangement, consider using a single composite description of each arrangement and its corresponding triggering events, simply highlighting significant variations between named executive officers. Also, it may be prudent to avoid the often lengthy and technical terminology that governs these arrangements (such as "change-in-control," "cause," and "good reason"). Instead, use simple descriptions of these terms and refer investors to the source documents for the more complete definitions.

Finally, expect increased interest this year in the required disclosure of the estimated payments and benefits payable upon a termination of employment or change-in-control. With this in mind, we recommend providing enhanced explanations of how these estimates were calculated; particularly the assumptions that may have gone into your computations. Similar disclosure of any reimbursement or "gross up" arrange-

ments payable to offset the imposition of Section 280G tax liabilities should also be made. These reimbursements or gross ups, which can often dwarf the change-in-control payments themselves, continue to come under fire and, thus, should be clearly explained.

This information may prove valuable both for purposes of validating these estimates as well as for explaining any variances with the actual amounts paid in the event that a termination or change in control occurs. Compensia, through its CompNumerics subsidiary, has significant experience in assisting companies in calculating these estimated payments and benefits. If you need any assistance in complying with these disclosure requirements, or have any questions on this area, please feel free to contact us.

10. Don't Forget the Details to Supplement Your Director Compensation Table

With your CD&A and executive compensation tables receiving so much attention, don't overlook the need to provide comprehensive information about your compensation arrangements for the members of your Board of Directors. In many respects, compliance here should be relatively straightforward as the Director Compensation Table conforms in most respects to the Summary Compensation Table. However, don't forget that you need to supplement the DCT with detailed information about equity awards (both those granted during the last completed fiscal year as well as the awards outstanding at fiscal year-end), perquisites, and any retirement plans or nonqualified deferred compensation arrangements for your directors. If you get stuck with an interpretive question, remember that many of the disclosure requirements for the SCT (and, correspondingly, the Staff's interpretive guidance) apply equally to the DCT.

Bonus Tip

11. Recognize the Increased Interest in Your Compensation Consultant

While the executive compensation disclosure rules only require companies to identify and explain the role of any compensation consultants and other advisors who assist the company or the Board Compensation Committee in recommending or determining executive and director compensation, in 2008 many companies also addressed their consultant's independence or, if not independent, the steps they had taken to eliminate potential conflicts of interest. Given the warm reception that this disclosure received from the investor community, we expect that it will continue to grow in popularity this year. Accordingly, we recommend that you stay ahead of this trend by disclosing your policy or practice with respect to compensation consultant independence (or provide a summary thereof), as well as any other relevant information that bears on the consultant's ability to provide impartial counsel and advice to the Board of Directors or Board Compensation Committee. If the consultant's relationship is exclusively with the Compensation Committee, don't hesitate to say so. Where the consultant also advises management or provides other services to the company, it may be wise to disclose the nature of, and/or fees received for, these services.

Final Observations

In preparing this year's executive compensation disclosure, companies should be sensitive to the current economic environment, even though many of the issues that are likely to be debated in 2009 will have had little or no impact on their 2008 compensation policies or decisions. As a practical matter, this may mean discussing how your executive compensation program will operate in 2009 and any changes that are being (or have been) made in view of the ongoing economic crisis; even though in a normal year such a discussion would not be required (unless material to an understanding of your compensation decisions for the most recently completed fiscal year).

In addition, companies should begin refining their disclosure to comply with the Commission's plain English principles. While the emphasis in 2008 appropriately was on getting the substantive content of the disclosure right, in 2009 the expectation will be that

CD&A's should be getting easier to read. Given the nature and scope of the discussions that will be needed in most CD&As, this will require faithful adherence to plain English, as well as creative use of tables, charts, and graphs to present complex or detailed information. It will also require more sophisticated decisions about which information is critical to explaining your compensation policies and practices and which can be relegated to other parts of the disclosure. While we may still be a few years away from shorter presentations, there's no reason why companies can't be improving the quality of their CD&As while we move in that direction. ■

About the Author

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