THOUGHTFUL PAY ALERT

Compensia

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Enhancing Your 2008 Executive Compensation Disclosure

The 2008 proxy season is underway, and most companies are busy rewriting their compensation discussion and analyses and updating their compensation tables for this year's proxy statement. Now that we've had a year's experience with the SEC's new executive compensation disclosure rules, and given the feedback from the SEC Staff last fall through its focused review project and October report, expectations are high that this year's disclosures will show a marked improvement over the initial efforts. Consequently, you should expect that your 2008 disclosure will be closely scrutinized by your investors, the media, your employees, and regulators.

With that in mind, we offer 10 tips to enhance the quality of your 2008 disclosure. These items, which we have compiled from our experience in helping numerous companies prepare their disclosure, as well as from what we've learned through the Staff's review and comment process, will improve the presentation, content, and clarity of your executive pay information.

We've divided our tips evenly between the Compensation Discussion and Analysis and the compensation tables. Since the rules require companies to clearly explain the rationale for their executive compensation policies and decisions, it should come as no surprise that the CD&A has replaced the Summary Compensation Table as the centerpiece of the required disclosure. Thus, because a well-written and concise CD&A is now the key to an effective presentation, we share our insights into how this report should be prepared.

While the compensation tables are still important, in 2007 most companies had little difficulty in mastering the requirements of the new rules – probably because of their extensive experience under the former rules in preparing tabular disclosure. Here, we offer suggestions on how to make the tables easier to navigate and read, which should eliminate potential confusion and enable investors to locate information more quickly.

Enhancing Your Compensation Discussion and Analysis

1. Be Precise

When preparing your CD&A, assume that your audience isn't familiar with your executive compensation program or how these programs work. What may be obvious to you may not be apparent to an outsider. Consequently, be thorough and logical in explaining how your compensation policies were applied and pay decisions made during the last completed fiscal year. Also, don't say things casually. As the SEC Staff's focused review project demonstrated, readers will take what you say literally. Thus, it's important to be precise. For example, don't say you "benchmarked" your compensation against that of other companies if you didn't actually perform a comparative evaluation. Similarly, don't say that your compensation committee exercised its discretion to make specific compensation decisions if, in fact, it didn't.

2. "Negative Disclosure" Isn't Required

At times, it has appeared as if the SEC Staff expects companies to affirmatively confirm whether or not they had engaged in specific practices or taken specific actions in setting executive pay as reflected in the 15 examples of potentially material disclosure set forth in the rules. Comments such as "explain how tally sheets were used to reach specific compensation decisions" and "explain the material differences in your compensation policies and decisions that resulted in the disclosed disparity in total compensation (or individual

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award amounts) between named executive officers" seem to suggest that "negative disclosure" is needed to verify that each example was considered and either has been addressed or didn't apply. However, the Staff has confirmed that the examples need to be covered only if they are material to an understanding of your executive compensation program or to making a voting decision. Consequently, we recommend that your discussion focus on the information that is material to explaining how your compensation policies were applied and how your pay decisions were made. Treat the examples as a guide, not a checklist, for this purpose.

3. Eliminate Narrative Descriptions Where Possible

The SEC Staff's most persistent comment about the 2007 CD&As was that they were too descriptive and not sufficiently analytical. It's difficult to argue with this observation. Many companies filled their CD&As with lengthy narrative summaries of their executive compensation plans and arrangements, rather than explaining how their compensation policies were applied and pay decisions reached. In preparing this year's CD&A, we recommend that you draft your discussion to include specific details only where they are material to the topic being discussed. This should help you focus on analyzing your pay policies and decisions. Be sure to move these descriptive summaries to the narrative discussions accompanying your compensation tables. That's where they belong.

4. Use a Table to Explain Your Annual Incentive Plan

When it comes to annual bonuses and other annual incentive awards, most investors are interested in two things: how much did you pay and how challenging were the target levels that the compensation committee set for the related performance measures? When answering these questions, we recommend that you avoid bogging down readers with a lengthy narrative explanation. Instead, consider using a chart to highlight the key information about your bonus or incentive plan, such as the relevant performance measures, their target levels, actual performance against those target levels, the potential bonus or award opportunity, and the actual payout. Among other benefits, a table will make this information easier to find – and understand. It may also help you shorten your CD&A, an otherwise difficult task this year.

5. Substantiate Competitive Harm Thoroughly and with Particularity

While you aren't required to obtain SEC approval before withholding target levels from the discussion of your performance-based incentive and equity plans, it's critical to have performed the "competitive harm" analysis before, rather than after, filing your proxy statement. We recommend documenting your competitive harm argument; taking care to ensure that the analysis is specific and tailored to your company's particular facts and circumstances. We also recommend that your analysis cover the following three points:

- It should provide context as to the dynamics of your industry and the competitive environment
- It should thoroughly explain how a competitor could take the target level disclosure and use it to determine a specific aspect of, or insight into, your business
- It should explain how the competitor could use this information in a manner detrimental to the company

Enhancing Your Compensation Tables

6. Bring Your Perquisites Front and Center

While perquisites and other personal benefits comprise a fraction of your executives' total compensation, investors consider them a key barometer of a company's executive compensation philosophy. Given their significance, your perquisites should be easy to locate and easier to understand. Although typically disclosed in a footnote to the Summary Compensation Table, we

recommend that you use a table – rather than a narrative paragraph – to identify and quantify any perquisites that you provided to your named executive officers. A table is easier for investors to find – and read. More importantly, where your executives receive only nominal perquisites, this is immediately evident from a table – sending a powerful, and positive, message to your investors.

7. Label Your Plan-Based Awards

The table that supplements the Summary Compensation Table – the Grants of Plan-Based Awards Table -- requires itemized disclosure of the cash incentive awards, stock options, and other equity awards made during the last completed fiscal year. For most investors, it's difficult to connect this detailed information to the SCT, or to the related discussion in the CD&A. Moreover, the arcane headings to the table's columns are not readily decipherable by most investors. We recommend adding a column to the left side of the table (following the column identifying each named executive officer) to label the awards being reported. By using the same terminology as in the CD&A and SCT (for example, annual incentive award, stock option, restricted stock award), it will be much easier for your investors to understand the information being presented in this table.

8. Streamline Your Vesting Information

The Outstanding Equity Awards at Fiscal Year-End Table requires that you list, on a grant-by-grant basis, all of the outstanding stock options held by your named executive officers at fiscal year end. The rules also require that you disclose the vesting schedules of the equity awards being reported. Since it's not uncommon for executives to hold numerous unexercised options, this latter disclosure requirement frequently leads to extensive lists of footnotes describing the details of each individual vesting arrangement. To reduce these lengthy (and, frequently, unreadable) footnotes, we recommend adding a column to the left side of the table (following the column identifying each named executive officer) to report the grant date of each option included in the table. This way, you can use a single footnote describing your standard vesting arrangements that is linked back to the reported grant date.

9. Simplify Your Termination and Change-in-Control Disclosure

After the CD&A, the second longest section of most companies' 2007 disclosure was the discussion of the severance and change-in-control arrangements for their named executive officers. Since the rules do not dictate the format of this disclosure, it represents the best opportunity for reducing the length of your overall executive compensation presentation. While you need to be mindful of satisfying the substantive requirements of the rules, here are three considerations for reformulating this disclosure:

- Use a single description of each potential triggering event, simply highlighting significant variations between named executive officers. This should reduce the often repetitious summaries of each individual executive's arrangements.
- Avoid the often lengthy and technical definitions that govern these arrangements (such as "change-in-control," "cause," and "good reason"). Instead, use simple descriptions of these terms and refer readers to the source documents for the more complete definitions.
- Where feasible, consolidate the presentation of estimated payments and benefits into a single table. There are many examples of tables that effectively combined each potential triggering event and the itemized payments and benefits payable to each named executive officer. Find a format that you like and adapt it to your program.

10. Director Compensation Table = Summary Compensation Table

While companies had little difficulty adapting to the new Director Compensation Table, some didn't fully appreciate its relationship to the Summary Compensation Table. In fact, most of the SEC Staff's comments on the DCT were aimed at reminding companies that many of the disclosure requirements for the SCT apply equally to the DCT. When preparing the DCT, if you encounter a compliance question that isn't addressed by the DCT rules, we recommend that you refer to the SCT rules for guidance. Also, don't forget the overriding instruction to the DCT, which tells you which of the SCT requirements specifically apply to the director table.

Final Observations

In preparing this year's executive compensation disclosure, many companies are likely to struggle with the SEC's conflicting messages from 2007: your disclosure is too long, and your disclosure doesn't provide enough detail. While these messages may seem irreconcilable at times, with careful drafting, faithful adherence to the plain English principles, and the creative use of tables, charts, and graphs, both can be successfully addressed. However, we believe that this proxy season the emphasis should be on getting the substantive content of your disclosure right. Once that has been done, then, in future years, you can focus on ways to streamline your presentation. ◆

About Compensia

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management. Formed in 2003 by a group of leading executive compensation experts with more than 60 years of experience, our mission is to offer Thoughtful Pay™ solutions in an ever-changing executive compensation landscape.

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