# 10 Tips for Enhancing Your 2014 Executive Compensation Disclosure

In the seven years since the Securities and Exchange Commission last overhauled its executive compensation disclosure rules, the quality of disclosure has improved markedly. The introduction of the Compensation Discussion and Analysis has not only altered the way board compensation committees design compensation programs, it has also placed greater emphasis on explaining clearly and concisely how and why specific compensation actions were taken. Moreover, the enactment of the mandatory shareholder advisory ("Say-on-Pay") vote on executive compensation in 2011 accelerated the use of innovative techniques to present pay information, with most large cap companies now routinely using charts, tables, and other graphics to tell their compensation story. Perhaps the most significant effect of Say-on-Pay has been the focus on "pay-for-performance." Once just a buzzword, today companies devote a significant portion of their disclosure to demonstrating the alignment of their executive compensation decisions with their financial and operational performance.

As we enter the 2014 proxy season, we once again offer 10 tips to enhance the quality of your executive compensation disclosure. These tips, which are based on our experience in advising numerous companies on preparing their disclosure, as well as what we've learned from our interactions with the Staff of the SEC's Division of Corporation Finance, are aimed at ensuring that your executive compensation disclosure is sound and effective in the current environment.

As in past years, we've divided our tips between the CD&A and the compensation tables, along with an initial tip concerning the proxy summary – an unforeseen disclosure technique that has now become a mainstay for most large cap companies. In recognition of its ongoing prominence in the required disclosure and the importance of providing a comprehensive and transparent explanation of your executive compensation policies and practices, these tips are more heavily oriented towards the CD&A.

### 1. The Proxy Summary is Here to Stay

The most unexpected consequence of the introduction of Say-on-Pay during the 2011 proxy season was the emergence of the so-called "proxy summary." Essentially, the proxy summary is an extension of the concept of an executive summary to the Compensation Discussion and Analysis (which is now routinely employed by most companies to summarize the most important aspects of their CD&A) to the entire proxy statement. Today's summaries cover the key items contained in the company's proxy materials, as well as a summary of the matters that are being presented for shareholder consideration and action at the annual meeting. As an area that isn't subject to any minimum requirements or maximum constraints (other than the SEC's general rules for preparing shareholder solicitation materials), there has been a great deal of variety in these disclosures as companies tailor them to their own specific needs and situation.

While initially limited to large cap companies, during the 2013 proxy season we began to see proxy summaries appear in the proxy statements of several mid-cap companies (as well as a handful of small cap companies). For most of these companies, the proxy summary serves as a high-level overview of the scheduled agenda for their annual meeting that highlights key information relevant to shareholder voting decisions – such as the backgrounds of director-nominees and the key compensation actions and decisions for senior management.

With most companies now beginning to view their proxy statement as a "communications," rather than merely a "compliance," document – particularly as it involves the presentation of executive compensation information, we believe that a proxy summary is an effective way to highlight the key messages that you want your shareholders to receive prior to the annual meeting and, perhaps more importantly, before they cast their vote on your Say-on-Pay proposal.

While the contents of a proxy summary can vary, most tend to include the following items

- the logistical information for the annual meeting of shareholders;
- the meeting agenda;

- the matters being submitted for shareholder action, including the company's recommendation on each matter;
- background information on the individual nominated to serve on the company's board of directors;
- summaries of the material information about any employee stock or benefit plan being submitted for shareholder action;
- a supporting statement for the Say-on-Pay proposal (if an agenda item);
- an abbreviated Summary Compensation Table (typically covering only the last completed fiscal year);
- the Board of Directors' recommendation for the ratification of the company's choice of auditors; and
- the deadline for submission of shareholder proposals for the following year's annual meeting.

It's important to note that, with the use of proxy summaries becoming more common each year, the decision to add such a summary should be made based on each company's overall messaging objectives. For example, adding a proxy summary may make more sense in a year where you are facing messaging challenges – such as the prospect of a problematic Say-on-Pay vote – than in a year where shareholder approval of your executive compensation is assured. Alternatively, if you have limited resources to devote to enhancing your executive compensation disclosure in a given year, those resources may be better spent on your CD&A than on introducing a new section to your proxy statement.

## Enhancing Your Compensation Discussion and Analysis

### 2. Develop a Robust Executive Summary

Since the advent of Say-on-Pay, the executive summary, or compensation overview, has become the critical feature of the Compensation Discussion and Analysis. Briefly stated, the executive summary should be used to crisply state your key compensation message or messages. For most companies, this means serving as a de facto supporting statement for your Say-on-Pay proposal.

In today's environment, we recommend that your executive summary address the relationship between your company's performance (both financial and operational) during the last completed fiscal year and your executive compensation actions and decisions that resulted from that performance. This is the principal focus of institutional investors when evaluating a Say-on-Pay proposal. This subject can also serve as an effective – and concise – way to demonstrate that the overall design of your executive compensation program, as well as its individual incentive compensation components, is well aligned with creating sustainable long-term shareholder value.

In our experience, the selective use of graphics, where appropriate, can be a highly effective way to communicate this information. In 2013, we saw numerous examples of companies that used an array of tables, charts, and graphs to depict their financial performance and related compensation actions and decisions. We not only expect this trend to continue, but look for these graphics to become more sophisticated as companies become more comfortable with viewing their proxy statement as a communication, rather than a compliance, document.

Finally, remember that the use of an executive summary does not replace the requirement to provide a clear and complete analysis (the "how and why") of your executive compensation actions and decisions in the CD&A. The primary purpose of the CD&A remains to explain the connection between a company's compensation philosophy and policies and the amounts reported in the compensation tables, not merely recite the principal elements of the company's executive compensation program. While the necessary analysis will vary from company to company, an effective CD&A will explain the purpose of each material compensation element, describe how the board compensation committee arrived at the specific levels of compensation paid to the named executive officers, and give the reasons for these compensation decisions.

### 3. Your Pay-for-Performance Message Should be at the Center of Your Disclosure

Over the past three years, the executive summary to the Compensation Discussion and Analysis has evolved from a bullet list of compensation highlights to a fulsome explanation of the company's pay-for-performance philosophy and how that philosophy is reflected in its executive compensation actions and decisions. As evidenced in each of these years, a majority of the companies that either saw their Say-on-Pay proposal fail or registered significant opposition to their executive compensation program were first labeled as companies with a pay-for-performance "disconnect." Thus, we expect that this subject will continue to be the centerpiece of most executive summaries in 2014.

Where your pay-for performance analysis doesn't align with the methodologies used by the proxy advisory firms, it will be critical to spell how the board compensation committee frames its analysis. It may also be necessary to explain why your analysis is preferable to that of the advisory firm and how your approach is better able to track shareholder value creation. In our experience, investors are receptive to these analyses, but require that companies make their case clearly and convincingly.

In both 2012 and 2013, we saw numerous companies illustrate the correlation between company financial performance and executive pay in graphic form. This is likely to continue to be the prevalent means for highlighting these relationships. In selecting a performance measure for these purposes, it's important to ensure that the measure is meaningful, not only from the standpoint of evaluating performance from year to year, but also as it relates to the design of your incentive compensation arrangements. Also, whether you use the compensation of just your chief executive officer, the named executive officer group, or your entire executive officer group, it's important to make sure that the calculation of total pay is sound and consistently applied. Companies that change the measures and/or calculations used to track pay and performance too often risk undermining the integrity of this disclosure.

Finally, we expect that in the near future the SEC will implement the "pay versus performance" disclosure requirement of Section 953(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. This provision will require companies to disclose in their proxy materials the relationship between executive compensation actually paid and company financial performance. We believe that this new disclosure requirement may compliment the move towards more rigorous pay-for-performance discussions. Consequently, it may be worthwhile to develop your pay-for-performance message with an eye towards how it may also be used to eventually satisfy this disclosure requirement.

### 4. "Realized" and "Realizable" Pay Disclosure Has Become the New "Alternative SCT"

Remember how, during the initial years following the adoption of the new executive compensation disclosure rules, companies would use an "alternative" summary compensation table to address the differences in the reporting of cash and equity awards? Those alternative tables faded away after the SEC changed its requirements for the reporting of equity awards in the Summary Compensation Table on the eve of the 2010 proxy season.

Nonetheless, the reporting of equity awards in the Summary Compensation Table continues to present problems for companies, particularly when making a "pay-for-performance" presentation in the Compensation Discussion and Analysis. While the proxy advisory firms use most of the amounts reported in the Summary Compensation Table to establish the chief executive officer's total compensation for the last completed fiscal year, as we know ISS re-computes the grant date fair value of stock options using the full option term and uses the target value for performance-based full-value awards. Many companies believe that these amounts overstate the actual compensation received by their executive officers from these awards. As a result, many companies have opted to provide disclosure of "realized" or "realizable" pay in their CD&A as a counterweight to the "reported" pay of the Summary Compensation Table.

Unlike an "alternative" summary compensation table, introducing realized or realizable pay disclosure into your CD&A shouldn't be a foregone conclusion. In our view, the decision to present realized or realizable pay should be made strategically; that is, it should be used when it is warranted by the situation at hand and not merely because it has become a popular disclosure item generally. Before adding realized or realizable pay disclosure to your CD&A, it's worth asking yourself two questions: (i) do we have a potential "pay-for-performance" alignment issue with our executive compensation program, and (ii), if so, can we better explain the effectiveness of our executive compensation program by comparing our short-term (one-year) and long-term (three-year) financial performance against the compensation actually paid to our chief executive officer (and, possibly, other named executive officers)? If the answer to each of these questions is "yes," then it may be appropriate to use realized or realizable pay disclosure to explain your executive compensation actions and decisions. If the answer to the first question is "no," then such disclosure may not yet be appropriate for purposes of telling your executive compensation "story." Remember that the point of realized or realizable pay, rather than total reported pay, disclosure is to better understand how the amounts awarded have changed from their original target values to what the executive officer has actually received or may receive.

Also, before using realized or realizable pay disclosure it's important to understand the differences between these two ways to define "pay" – "realized" pay is the amount that has been realized (that is, the amount actually "earned") by the executive officer, while "realizable" pay is the amount that the executive officer has received and may receive in the future (that is, the amount actually earned plus the unrealized appreciation inherent in outstanding equity awards as of a fixed date (typically, the last day of the most recent fiscal year)). First, it's important to understand that the sole difference between "realized" and "realizable" pay involves the treatment of equity, rather than cash, compensation. Cash compensation, in the form of base salary and annual incentive compensation, is calculated in the same manner and produces the same result under either approach. It's in the area of equity compensation that differences arise. And, unsurprisingly, each approach has its advantages and disadvantages. "Realized" pay is essentially the amount that an executive officer has been able to put into his or her pocket from his or her equity compensation opportunity – either through the exercise of outstanding and vested stock options and/or the vesting of full-value share awards. It is easy to compute, and finite. On the other hand, since in the case of stock options, the date of exercise is within the control of the executive officer, using the amount realized on exercise can distort the pay-for-performance analysis. "Realizable" pay is a forward-looking estimate of what the executive officer is likely to be able to put into his or her pocket in the future based on the current value of outstanding – but unvested – stock awards. ("Realizable" pay also takes into account the amount that has been previously realized from equity awards as well.) It's more speculative than "realized" pay, but potentially a more precise calculation since it assigns a value to current awards the final economic value of which won't be known until a future date. Yet, even this approach has its uncertainties. For example, the treatment of stock options (that is, whether to value using an option pricing model or simply using the "intrinsic" value) is problematic. And, this problem is more acute in the case of "underwater" stock options.

Finally, it's also important to note that "realizable" pay doesn't always produce a better result. While most companies that have employed a realized or realizable pay disclosure to date have done so because the amounts earned (or to be earned) by the subject executive officer are less than the comparable amounts reported in the Summary Compensation Table, this won't necessarily be the case in each subsequent fiscal year. In fact, over any multi-year measurement period, it is just as likely that an executive officer's realizable pay will be greater than his or her reported pay. Since we believe that the use of realized or realizable pay on a selective basis (that is, only in fiscal years where it generates a company-favorable result) would undermine the credibility of the disclosure, a company needs to be sure that it will be comfortable providing this disclosure each year going forward before proceeding with this approach.

### 5. Consider Addressing Your Shareholder Engagement Efforts

While the SEC requires companies to address in the Compensation Discussion and Analysis whether and, if so, how they considered the results of their most recent Say-on-Pay vote (during the 2014 proxy season, that will be your 2013 vote) in determining their compensation policies and decisions, as well as how that consideration affected their executive compensation decisions and policies, most companies have developed a standard response to this disclosure requirement. More challenging has been the policy of Institutional Shareholder Services ("ISS") specifying that where a company's most recent Say-on-Pay proposal received "significant opposition" (that is, the Say-on-Pay proposal received the support of less than 70% of the votes cast), the company should disclose its engagement efforts with its major institutional investors regarding the issues that contributed to the low level of support, including the specific actions taken to address the issues that contributed to the low level of support. In both 2012 and 2013, we noted instances where ISS issued an unfavorable recommendation on a Say-on-Pay proposal where a company failed to address its shareholder engagement efforts in its executive compensation disclosure.

To avoid this outcome, we recommend that you prominently and clearly disclose your shareholder engagement activities following a failed Say-on-Pay vote or where you have registered significant opposition to your Say-on-Pay proposal. We note that shareholder engagement does not mean capitulation on the part of the company. Engagement should generate a substantive discussion with key shareholders to understand their concerns and the reasons for their vote. From this engagement, the board compensation committee can decide how to respond after taking into consideration the interest of the company and shareholders as a whole. From a disclosure perspective, you should consider disclosing:

- the extent of your engagement activities;
- the information gleaned from shareholders:
- the response (if any) of the company; and
- when any compensation program changes will take effect.

Remember that this subject often involves a timing mismatch – compensation decisions for the current fiscal year often will have taken effect by the time of the Say-on-Pay vote. Thus, it's important to disclose that any changes to your executive compensation program made in response to shareholder input will not necessarily be reflected in the subsequent year's disclosure (which will reflect the compensation actions taken before the subject Say-on-Pay vote).

Even where shareholders have expressed overwhelming support for your executive compensation program (and, thus, you are not subject to the ISS policy), we recommend that you consider addressing your routine engagement efforts with your major institutional shareholders. In our experience, this information provides a useful backdrop to any discussion of your Say-on-Pay vote and helps investors better understand how your company communicates with shareholders on executive compensation matters and other issues of concern.

### 6. Thoroughly Cover Your Performance Measures and Related Target Levels

Even after seven years, we would be remiss if we didn't stress the ongoing importance of thoroughly discussing the details, including the performance measures and related target levels, for your short-term and long-term incentive compensation plans and arrangements. While SEC Staff comments on this subject have largely subsided, newly public companies that are not emerging growth companies and EGCs that have recently lost such status should expect the Staff to closely scrutinize their incentive compensation disclosure for compliance in this area. Further, the triennial review of a company's periodic reports filed under the Securities Exchange Act of 1934 will likely include a careful review of the Compensation Discussion and Analysis and the discussion of incentive compensation.

Even where the target levels for a performance measure have been missed, the SEC Staff continues to emphasize that this information may be material to investors (for example, illustrating how the board compensation committee sought to motivate the company's executive officers). Further, if a company has paid its executive officers incentive compensation even though the relevant performance target levels were not met, it may raise questions for investors as to whether the target levels, and related compensation, were sufficiently risk-sensitive since the compensation was paid without regard to the performance outcome.

We believe that you should carefully consider asserting a "competitive harm" argument to shield your performance measure target levels from disclosure – particularly in the case of short-term incentive compensation arrangements – before doing so. In our experience, unless you have a strong (and reasoned) basis for your position, you run the very real risk of having to amend your disclosure if challenged on SEC Staff review. When considering a competitive harm claim, you should assess the merits of your argument contemporaneously (and not at the time of a subsequent Staff inquiry). Remember that, where you rely on a competitive harm exception, you should assume that eventually you will be called upon to justify any such assertion to the Staff. Consequently, a critical assessment of your position is not just an academic exercise.

In our experience, when it comes to incentive compensation investors are most interested in two things: how much did you pay and how challenging were the target levels that were set for the associated performance measures? 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.

### 7. Explain How You Selected Your Compensation Peer Group

An area on increasing investor interest involves the use of comparative data by companies to set executive compensation levels, including the role of compensation "benchmarking." Under the executive compensation disclosure rules, when 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 SEC Staff insists on meaningful disclosure as to how the peer group was selected and the relationship between the actual compensation levels and the data used in any benchmarking study.

For many investors, this information is useful in understanding how a company's executive compensation program works and how the board compensation committee reached specific pay decisions. Consequently, we recommend that you devote sufficient attention to this subject when drafting your Compensation Discussion and Analysis. As we have stated in the past, when it comes to the basis for developing a compensation peer group, more, rather than less, information 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.

### 8. Analyze, Don't Simply Describe, Your Post-Employment Compensation Arrangements

Many companies continue to be unsure as to how to address their post-employment compensation arrangements in the Compensation Discussion and Analysis. While these companies provide a thorough description of the material terms and conditions of these arrangements, they frequently overlook the primary topic that should be addressed in the CD&A – the reason for providing the post-employment compensation in the first place and how it relates (if at all) to the other elements of the executive compensation program. In addition, many companies fail to explain the rationale for the structures of these arrangements (compared with other alternatives) and how specific payout amounts or formula are determined. As we have noted in the past, the CD&A 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, including the estimated amounts potentially payable upon a termination of employment or a change-in-control of the company, should be part of your Potential Payments upon Termination or Change-in-Control disclosure, rather than the CD&A.

## Enhancing Your Compensation Tables

### 9. Use Narrative Disclosure to Supplement Your Grants of Plan-Based Awards Table and Outstanding Equity Awards at Fiscal Year-End Table

While companies have clearly mastered the presentation of the primary supplemental tables to the Summary Compensation Table – the Grants of Plan-Based Awards Table and Outstanding Equity Awards at Fiscal Year-End Table, a cursory review of those tables is often challenging, if not impossible, given the morass of lengthy and confusing footnotes that often accompany the tables. Much to our surprise, many companies have not taken advantage of the rules concerning supplemental narrative disclosure to the SCT and the Grants of Plan-Based Awards Table to present this information in a more coherent fashion. Further, the SEC Staff does not appear to enforce the application of this rule consistently, thereby causing it to be largely overlooked.

The executive compensation disclosure rules provide that the Summary Compensation Table and the Grants of Plan-Based Awards Table should be accompanied by a narrative description of any material factors necessary to an understanding of the information disclosed in these tables. Examples of such factors include:

- The material terms of each named executive officer's employment agreement or arrangement, whether written or unwritten;
- The terms and conditions of any material modification (including a repricing) to any outstanding option or other equity-based award or the change or elimination of applicable performance criteria;
- The material terms of any award reported in the Grants of Plan-Based Awards Table, including a general description of the formula or criteria to be applied in determining the amounts payable, and the vesting schedule; and
- An explanation of the amount of salary and bonus in proportion to total compensation.

Although we see companies provide some of this information in one or more footnotes to the relevant table, these footnotes are often truncated, confusing, and overlap with the footnotes required as part of the Outstanding Equity Awards at Fiscal Year-End Table. We recommend using narrative disclosure to provide much of this information, particularly as it relates to the design and operation of a short-term incentive compensation plan and the material terms and conditions of equity and non-equity incentive compensation plan awards granted during the last completed fiscal year. The format is more conducive to a thorough presentation of this information. In addition, much of this information can be shifted from the Compensation Discussion and Analysis to this disclosure, thereby providing an avenue for combatting the "disclosure creep" to the CD&A that many companies face.

As for the Outstanding Equity Awards at Fiscal Year-End Table, the most common supplemental disclosure that is required involves the presentation of the vesting arrangements for outstanding stock and option awards. Over the years, this has resulted in lengthy – and often indecipherable – footnote lists reciting the specific vesting schedules for each award. This outcome can be avoided, however, with just a little additional work. Several companies have added a column to the table, immediately following the "Name" column and immediately before the "Option Awards - Number of Securities Underlying Unexercised Options (Exercisable)" column, setting forth the grant date for each equity award outstanding at the end of the fiscal year. A generic description of the vesting schedule for each category of award can then be linked back to the grant date information to satisfy the disclosure requirement without the need for providing a separate customized description of the vesting schedule for each award.

### 10. Consider Streamlining Your Post-Employment Compensation Disclosure

Post-employment compensation arrangements, particularly those associated with a termination of employment or a change-in-control of the company, continue to be an area of investor concern. Given the complexity of these arrangements and the potential for salacious media headlines, we believe that, after the Compensation Discussion and Analysis, this is the disclosure area that requires your closest attention. It is imperative that your descriptions of these arrangements be easy to follow and understand, and that the estimates of potential payments and benefits be clear and accurate. For example, instead of providing a detailed description of each arrangement, consider using a single composite description of your arrangements and the corresponding triggering events, simply highlighting significant variations between named executive officers. Also, we have found it prudent to avoid the use of the technical jargon that typically governs these arrangements. Instead, use simple descriptions of these terms and refer investors to the source documents for the more complete definitions.

We also recommend providing enhanced explanations of how the estimates of potential severance and change-in-control payments and benefits were calculated; particularly the assumptions that may have gone into your computations. 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 subsequently occurs.

Finally, the executive compensation disclosure rules do not require that the Potential Payments upon Termination or Change in Control disclosure come at the end of your executive compensation disclosure. This placement is largely a result of where the disclosure requirements fall in the rules themselves. Given the interest in this information, consider moving it forward – including it immediately following the Summary Compensation Table is one possible alternative.

## Need Assistance?

Compensia has had significant experience in helping companies to prepare their executive compensation disclosure. If you have any questions on the subjects addressed in this Thoughtful Pay Alert or would like assistance in preparing your executive compensation disclosure, please feel free to contact Mark A. Borges. ■

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