10 Tips for Enhancing Your 2010 Executive Compensation Disclosure

The 2010 proxy season is shaping up as one of the most momentous in recent memory. On December 16, 2009 – less than three weeks ago, the SEC adopted a package of enhancements to its proxy disclosure rules, including several changes to its executive compensation disclosure requirements. The timing of the Commission's actions doesn't give companies much time to collect and analyze the potentially voluminous information needed to make a series of key disclosure decisions before they must file and disseminate their proxy materials.

In addition, the SEC Staff has raised the stakes dramatically if a company's executive compensation disclosure is inadequate or incomplete. In November 2009, the Deputy Director of the SEC's Division of Corporation Finance announced a tough new standard for its review of the Compensation Discussion and Analysis and related compensation tables. Where, in past years, the Staff would address disclosure shortcomings through the issuance of so-called "futures" comments (essentially instructing a company to correct a deficiency in its next required filing that included executive compensation disclosure), beginning in 2010 where it identifies a material deficiency in a company's disclosure and it is clear that the company is not following the executive compensation disclosure rules or the Staff's guidance on complying with the rules, it will require an amendment to the problematic disclosure (typically, through an amendment to the company's annual report on Form 10-K). Consequently, companies that have been under the impression that they are not obligated to update their disclosure unless expressly requested by the Staff to do so are on notice that the Staff expects all companies to follow its public compliance pronouncements, whether they take the form of formal Staff positions or comments to other companies.

Finally, we continue to see the aftermath of the recent global economic recession through a series of regulatory and legislative initiatives intended to reform corporate governance and compensation practices that are believed to have contributed to the financial crisis. While most of these measures are still pending before Congress, for some – such as an advisory vote on executive compensation and universal compensation recovery ("clawback") policies – it's simply a matter of when, and not if, they will be enacted. Accordingly, companies should start to identify how their executive compensation disclosure will need to change to accommodate these anticipated new requirements and begin to lay the groundwork in their 2010 disclosure.

With these developments in mind, we once again offer 10 tips to enhance the quality of your 2010 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, should help ensure that your executive pay disclosure is sound and effective in the current environment.

As in past years, we've divided our tips between the Compensation Discussion and Analysis and the compensation tables. In recognition of its continued prominence in the disclosure framework and the importance of providing a comprehensive and transparent explanation of your compensation practices and decisions, we've weighted these tips more heavily towards the CD&A.

Enhancing Your Compensation Discussion and Analysis

1. Job One is Still Providing a Thorough Analysis

It should come as no surprise that, throughout the fall, the SEC Staff has taken the opportunity to publicly state its dissatisfaction with the quality of the analysis that many companies provide in their CD&As. While this is to be expected given the subjective nature of this disclosure, it's a stark reminder that companies need to continue to focus on the "how and why" of their executive compensation policies and decisions when drafting the CD&A – and not get lost in the detail. It's important to remember that the primary 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 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 compensation committee arrived at the specific levels of compensation paid to its named executive officers, and give the reasons for these compensation decisions.

Most recently, the Staff has stated that the CD&A should:

- explain how a company determined the amounts for each material element of each named executive officer's compensation package, including what each compensation element is designed to reward; and
- provide meaningful insight into the company's compensation policies and decisions, including the reasons behind these policies and decisions.

As the Staff has noted, factual statements that simply describe the compensation-setting process or what the company or compensation committee did or did not do are insufficient.

2. And the Disclosure of Performance Metrics isn't Far Behind

Over the past three years, the SEC Staff has issued more comments on the adequacy of the disclosure about short-term and long-term incentive compensation arrangements than any other compensation item. The bulk of these comments involve the disclosure of the target levels for the performance metrics underlying these arrangements.

Recent experience suggests that the Staff has not relaxed its position with respect to the disclosure of performance metric target levels. Even in a year when many performance targets were missed because of the economic downturn, the Staff stressed that the target levels could be material if, in a given situation, they played an important role in the way the company sought to motivate its executives. Further, where a company paid its executive officers incentive compensation even though the relevant performance targets were not met, the Staff raised questions as to whether the targets, and related compensation, were sufficiently risk-sensitive since the compensation was paid without regard to the performance outcome.

We recommend that you avoid the temptation to claim "competitive harm" to shield your performance metrics and related target levels from disclosure unless you have a legitimate (and reasoned) basis for your position. 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). Where you rely on a competitive harm exception, you should assume that eventually your company 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 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. Risk Disclosure is Here to Stay

The SEC's recent proxy disclosure enhancements include a requirement that companies address the relationship of their compensation policies and practices to risk management if those compensation policies and practices create risks that are reasonably likely to have a material adverse effect on the company. This requirement is a direct outgrowth of the compensation standard imposed on financial institutions receiving federal assistance 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.

While the disclosure requirement is triggered only where a company's compensation policies and practices create risks that are "reasonably likely to have a material adverse effect" on the company (a fairly high materiality threshold) and then only to the extent that the risks affect the organization as a whole, companies will still need to conduct an internal risk assessment to reach an appropriate disclosure conclusion. Further, even where no disclosure is required, we expect that, in view of the interest in this subject, many companies will choose to address the subject of compensation and risk in their proxy statements; at a minimum acknowledging that the board of directors or compensation committee has conducted a risk assessment on an organization-wide basis. We believe that, for the foreseeable future, such disclosure should be provided – if only to reassure investors that your company is on top of this issue. And, while the new disclosure doesn't have to be included in the CD&A, it's likely to be the logical location for any "voluntary" risk discussion; particularly if, as we expect it will, the discussion focuses largely on your executive compensation arrangements.

Finally, don't forget that, apart from this new disclosure requirement, you may need to disclose other risk matters in your CD&A. As the SEC Staff has stated on numerous occasions, under the current rules, to the extent risk considerations are a material aspect of your compensation policies or decisions for your named executive officers, you are required to address them in your CD&A.

4. Highlighting Your Program's Risk Mitigation Features

While the substance of compensation-oriented risk assessments is still evolving, we expect that one subject that will be covered is the identification of any compensation program or plan features, as well as any corporate compensation policies and practices, which are intended, in whole or in part, to mitigate or eliminate risk. Interestingly, many of these features, such as compensation recovery ("clawback") policies and stock ownership requirements or guidelines, are already discussed in summary fashion in the CD&A; although not in the context of risk management.

Consequently, even in the absence of a required risk disclosure, we expect that many companies will revise the discussion of these features in their CD&A to emphasize how the risks generated by their incentive compensation plans and arrangements are within their ability to effectively monitor and manage because of the presence of these risk mitigation features. As a result, instead of simply tacking them on at the end of the CD&A in a section entitled "Other Compensation Policies," we recommend that these plan features and policies be given greater prominence in your CD&A as part of any "voluntary" risk-related discussion.

5. Be Sure to Explain How You Selected Your Peer Group

Another key area to the SEC Staff (and investors) has involved how companies use comparative data 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 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 investors, this information is useful in understanding how a company's executive compensation program works and how its compensation committee reached specific pay decisions. Consequently, we recommend that you devote sufficient attention to this subject when drafting your CD&A. As we have stated in the past, when it comes to the basis for developing a 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.

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

We have found that many companies continue to struggle with the discussion of their post-employment compensation arrangements, specifically amounts potentially payable upon a termination of employment or a change-in-control of the company, in their CD&As. While these companies tend to provide a thorough description of the 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. 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 suggested last year, 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 should be part of your Potential Payments upon Termination or Change-in-Control disclosure, rather than your CD&A.

7. Finally, Consider Using an Executive Summary

In spite of three years' experience drafting the CD&A, the disclosures have gotten longer, instead of shorter. With executive compensation programs getting more – not less – complex and new disclosure requirements in place, it's likely that this trend will continue for the foreseeable future. As a result, it is becoming increasingly more difficult for investors to parse the disclosures for the essential information they are seeking and for companies to convey their key compensation messages to their shareholders. Further, with a mandatory shareholder advisory vote on executive compensation looming on the horizon, it is expected that the CD&A will become the centerpiece of your company's efforts to persuade your shareholders to approve your executive compensation program.

In our view, these developments militate towards adding an executive summary to your CD&A to highlight the key points that you want to be sure investors take away from the discussion. An executive summary not only can serve as an effective way to communicate the central messages of your CD&A, but also as a supporting statement for a "Say on Pay' vote resolution.

While we are at least a year away from a mandatory "Say on Pay" requirement, we believe that it's not too early to add an executive summary to your CD&A. The precise content of an executive summary will vary from company to company; however, we recommend that it include a brief description of your company's business results for the last completed fiscal year (either directly or by reference to your Management Discussion and Analysis of Results of Operations and Financial Condition), a comparison of target and actual compensation for your named executive officers based on these results, a description of any material changes to your executive compensation program during the last completed fiscal year, and an overview of your principal executive officer's total compensation for the last completed fiscal year, highlighting his or her variable compensation elements.

Enhancing Your Compensation Tables

8. The "Alternative" Summary Compensation Table Survives

Although the change to the reporting of equity awards in the Summary Compensation Table will certainly simplify the preparation (and understanding) of this table, it's unlikely to eliminate the utility of an "alternative" Summary Compensation Table entirely. As we know, the SEC opted not to change its approach for when equity awards are to be reported in the Summary Compensation Table. Consequently, they will continue to be reported in the fiscal year when granted, rather than for the fiscal year in which the services giving rise to the award were performed. Since many equity awards are granted based, in whole or in part, on an executive officer's performance during the last completed fiscal year, the information presented in the Summary Compensation Table may not correspond to the discussion of his or her compensation in the CD&A. Accordingly, some companies may find it helpful to present the grant date fair value information in a reconfigured "alternative" table to enable investors to better understand the compensation committee's decisions.

In addition, going forward performance-based equity awards will be reported in the Summary Compensation Table using their grant date fair value based on the probable outcome of the performance conditions, rather than the maximum potential value of the award. While this will conform the required disclosure to the estimated compensation expense to be recognized for financial reporting purposes over the award's service period, it may not necessarily correspond to how the compensation committee evaluated the award for purposes of setting an executive officer's target total equity compensation (or total compensation generally). Once again, an "alternative" table may be a useful way to convey to investors the relevant information that formed the basis for the compensation committee's deliberations.

9. Pay Attention to Tax Payments

While perquisites and other personal benefits have been the principal "hot button" item for investors in prior years, as perquisite practices have begun to moderate tax reimbursement payments and tax "gross-up" arrangements have replaced them at the top of most lists of egregious compensation practices. In almost every situation, investors tend to object to these payments and arrangements, with their level of outrage corresponding directly to the dollar amount involved.

While it's unlikely that one of the proxy advisory firms or major shareholder groups will oppose your director slate or individual compensation committee members solely on the basis of the existence of a tax payment or "gross-up provision," with "Say on Pay" looming on the horizon, they will soon have another – and less drastic – avenue for registering their displeasure with these arrangements. We recommend that you inventory your executive compensation program for any tax payments or similar arrangements and, if they exist, determine whether they constitute a critical component of your program. Where such arrangements have been individually negotiated (and, thus, cannot be unilaterally altered) or play an important role in a specific compensation arrangement (such as in a change in control program), we recommend that you provide a clear and transparent explanation of the purpose, operation, and potential cost of such arrangements.

10. Don't Forget to Streamline Your Termination and Change-in-Control Disclosure

As we predicted, the potential payments to your named executive officers in the event of a termination of employment or a change-in-control of the company were subjected to heightened scrutiny in 2009, leading to some memorable headlines ("golden coffins" anyone?) and profound embarrassment for the identified companies. With these lessons in mind, we continue to recommend that you keep your 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 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.

Also, we 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 occurs.

Finally, the executive compensation disclosure rules do not require that your 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 us. ■

10 Tips for Enhancing Your 2010 Executive Compensation Disclosure (continued)

About Compensia

Compensia, Inc. is a management consulting firm that provides executive compensation advisory services to Compensation Committees and senior management.

San Francisco

770 Tamalpais Drive
Suite 207
Corte Madera, CA 94925
415.462.2990

Mark H. Edwards, Chairman
medwards@compensia.com
415.462.2985

Michael Benkowitz
mbenkowitz@compensia.com
415.462.2996

Mark A. Borges
mborges@compensia.com
415.462.2995

Southern California

Anna-Lisa Espinoza
alespinoza@compensia.com
858.509.1179

Mathew T. Quarles
mquarles@compensia.com
323.919.7338

Silicon Valley

1731 Technology Drive
Suite 810
San Jose, CA 95110
408.876.4025

Timothy J. Sparks, President
tsparks@compensia.com
408.876.4024

Thomas G. Brown
tbrown@compensia.com
408.876.4023

Susan Gellen
sgellen@compensia.com
408.907.4302

Tom LaWer
tlawer@compensia.com
408.907.4309